[JOINT COMMITTEE PRINT]

EXPLANATION OF PROPOSED INCOME TAX TREATY (AND PROPOSED PROTOCOL) BETWEEN THE UNITED STATES OF AMERICA AND THE REPUBLIC OF INDIA

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

ON JUNE 14, 1990

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

JUNE 13, 1990

U.S. GOVERNMENT PRINTING OFFICE
30-884 WASHINGTON : 1990 JCS-20-90

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402

J862-35
S382-20

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101st Congress, 2d Session

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CONTENTS

Page

INTRODUCTION 1

I. SUMMARY 2

II. ISSUES 9

III. OVERVIEW OF UNITED STATES TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX, TREATIES 18

A. United States Tax Rules 18
B. United States Tax Treaties—In General 21

IV. EXPLANATION OF PROPOSED TAX TREATY 24
Article 1. General Scope 24
Article 2. Taxes Covered 25
Article 3. General Definitions 26
Article 4. Residence 27
Article 5. Permanent Establishment 29
Article 6. Income from Real Property 31
Article 7. Business Profits 32
Article 8. Shipping and Air Transport 36
Article 9. Associated Enterprises 37
Article 10. Dividends 38
Article 11. Interest 40
Article 12. Royalties and Fees for Included Services 42
Article 13. Gains 53
Article 14. Permanent Establishment Tax 54
Article 15. Independent Personal Services 55
Article 16. Dependent Personal Services 56
Article 17. Directors' Fees 57
Article 18. Income Earned by Entertainers and Athletes 57
Article 19. Remuneration and Pensions in Respect of Government Service 58
Article 20. Private Pensions, Annuities, Alimony and Child Support 59
Article 21. Payments Received by Students and Apprentices 60
Article 22. Payments Received by Professors, Teachers and Research Scholars 60
Article 23. Other Income 61
Article 24. Limitation on Benefits 61
Article 25. Relief from Double Taxation 63

Page
Article 26. Non-Discrimination 65
Article 27. Mutual Agreement Procedure 66
Article 28. Exchange of Information and Administrative Assistance 67
Article 29. Diplomatic Agents and Consular Officers 69
Article 30. Entry Into Force 69
Article 31. Termination 70
Exchange of Notes 70

INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides an explanation of the proposed income tax treaty, as modified by the proposed protocol, between the United States and the Republic of India ("India"). The proposed treaty and protocol were signed at New Delhi on September 12, 1989, and were amplified by an exchange of notes and a memorandum of understanding signed the same day. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed treaty on June 14, 1990.

No income tax treaty is currently in force between the United States and India. A previous income tax treaty, which contained a "tax-sparing" provision, was signed on November 10, 1959, but never received the advice and consent of the Senate to ratification by the United States. The treaty was withdrawn from further consideration by the Senate on June 8, 1964.

The proposed treaty is similar to other recent U.S. income tax treaties, the 1981 proposed U.S. model income tax treaty ("U.S. model treaty"), and the 1977 model income tax treaty of the Organization for Economic Cooperation and Development ("OECD model treaty"). However, there are certain deviations from those documents. Some of the treaty's provisions are based on articles of the 1980 model treaty developed by the United Nations for use between developed and developing countries ("United Nations model treaty"). Other provisions are included in order to accommodate aspects of the Tax Reform Act of 1986 ("1986 Act").

The first part of this pamphlet summarizes the principal provisions of the proposed treaty and proposed protocol. The second part presents a discussion of issues raised by the proposed treaty and proposed protocol. The third part provides an overview of U.S. tax laws relating to international trade and investment and U.S. tax treaties in general. This is followed in part four by a detailed explanation of the proposed treaty including, where appropriate, explanations of the provisions of the proposed protocol and the memorandum of understanding.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty (and Proposed Protocol) Between the United States and the Republic of India* (JCS-20-90), June 13, 1990.

I. SUMMARY

In general

The principal purposes of the proposed income tax treaty and proposed protocol between the United States and India are to reduce or eliminate double taxation of income earned by citizens and residents of either country from sources within the other country, and to prevent avoidance or evasion of the income taxes of the two countries. The proposed treaty is intended to promote close economic cooperation between the two countries and to eliminate possible barriers to trade caused by overlapping taxing jurisdictions of the two countries. It is intended to enable the countries to cooperate in preventing avoidance and evasion of taxes.

As in other U.S. tax treaties, these objectives are achieved principally by each country agreeing to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other. For example, the treaty provides that neither country may tax business income derived from sources within that country by residents of the other unless the business activities in the taxing country are substantial enough to constitute a permanent establishment or fixed base (Articles 7 and 15). Similarly, the treaty contains certain visitor exemptions under which residents of one country performing personal services in the other are not required to pay tax in the other unless their contact with the other exceeds specified minimums (Articles 15, 16, 18, 21, and 22). The proposed treaty provides that dividends, interest, royalties, capital gains, and certain other income derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 10, 11, 12, and 13). Generally, however, dividends, interest, and royalties received by a resident of one country from sources within the other country are to be taxed by the source country on a restricted basis (Articles 10, 11, and 12).

In situations where the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the treaty generally provides for the relief of the potential double taxation by the country of residence allowing a tax credit for taxes paid to the country of source.

Like other U.S. tax treaties, the proposed treaty contains a "saving clause." Under this provision, the United States retains the right (with certain exceptions) to tax its citizens and residents as if the treaty had not come into effect. In addition, the treaty contains the standard provision that the treaty may not be applied to deny any taxpayer any benefits otherwise allowed under the domestic law of the country or under any other agreement between the two countries; that is, the treaty may only be applied to the benefit of taxpayers.

Differences in proposed treaty and model treaty

The proposed treaty differs in certain respects from other U.S. income tax treaties and from the U.S. model treaty. The major differences are as follows:

(1) The U.S. excise tax on insurance premiums paid to a foreign insurer is generally covered by the treaty. This is a departure from older U.S. tax treaties. The U.S. model and some recent U.S. treaties, such as the treaties with the United Kingdom, France, and Hungary, generally cover this excise tax.

(2) The proposed treaty provides rules for determining when a person is a resident of either the United States or India, and hence entitled to benefits under the treaty. The proposed treaty, like the U.S. model, provides tie-breaker rules for determining the residence for treaty purposes of "dual residents," i.e., persons having residence status under the internal laws of each of the treaty countries. Unlike the U.S. model, the proposed treaty does not treat a dual residence company as a resident of the country under whose laws it was created. The proposed treaty expressly provides that a dual resident company is generally outside the scope of the treaty.

(3) The definition of a permanent establishment in the proposed treaty is broader than that in the U.S. model and in many existing U.S. treaties. The principal areas in which the proposed treaty departs from the U.S. model are in its inclusion in the permanent establishment definition of a warehouse (in relation to a person providing storage facilities to others); a farm; a sales outlet; a drilling rig or ship or other installation or structure used for the exploration or development of natural resources in a country for more than 120 days (rather than 12 months); a construction project lasting more than 120 days (rather than 12 months); and an individual performing services (other than certain services to which royalty treatment applies under Article 12) for more than 90 days. Also, the inclusion in the time period of supervisory activity connected with construction activity is a departure from the U.S. model. These departures from the U.S. model, however, are similar to the corresponding provisions of the United Nations model treaty and other recent U.S. income tax treaties with developing countries. In addition, an independent agent of an enterprise constitutes a permanent establishment under the proposed treaty if the agent habitually secures orders in that other country wholly or almost wholly on behalf of that enterprise and the transactions between the agent and the enterprise are not made under arm's-length conditions; the U.S. model does not contain this rule, although a few U.S. treaties with developing countries do.

(4) The proposed treaty differs from the U.S. model in not providing investors in real property in the country not of their residence with an election to be taxed on such investments on a net basis. Current U.S. law independently provides a net-basis election to foreign persons. It is understood that Indian law provides for taxation of income from real property on a net basis.

(5) The proposed treaty departs from the U.S. model treaty's definition of "business profits" by excluding income from the provision of certain services or from the rental of certain personal property (see discussion under "Issues," Part II, following). Instead, such

income is treated similarly to royalties. Thus, such income is taxable in the source country on a gross basis (at a reduced rate), rather than on a net basis as business income.

(6) The proposed treaty provides that a country may estimate on a reasonable basis the business profits attributable to a permanent establishment in accordance with the principles contained in the Business Profits article, if the correct amount is incapable of determination or the determination presents exceptional difficulties. Recent U.S. income tax treaties and the U.S. model treaty do not contain this provision. This rule is expected to be applied only in unusual cases.

(7) In computing taxable business profits, deductions generally are allowed for expenses, wherever incurred, that are incurred for the purposes of the permanent establishment. These deductions include a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred by the head office of the enterprise. However, the proposed treaty precludes deductions for amounts paid by the permanent establishment to the head office of the enterprise (other than reimbursements of actual expenses) for the use of patents, know-how or other rights, or for specific services performed or for management services. These rules limiting deductions are not found in the U.S. or OECD model treaties, but are patterned after rules contained in the United Nations model treaty. Similar rules are contained in certain other U.S. income tax treaties with developing countries.

(8) The proposed treaty, unlike the U.S. model, provides that business profits can be attributed to a permanent establishment if they are derived from sales or other activities similar to those effected through the permanent establishment (even if not carried out by the permanent establishment). This rule is consistent with the United Nations model and certain other U.S. treaties.

(9) Consistent with changes made to the Internal Revenue Code by the 1986 Act, the proposed protocol specifies that a country may tax business profits that are properly attributable to a permanent establishment or fixed base, even after the permanent establishment or fixed base has ceased to exist.

(10) The Shipping and Air Transport articles of both the U.S. model and the proposed treaty permit only the country of residence to tax income from the operation of ships or aircraft in international traffic. The two treaties, however, contain certain differences with respect to the types of income which qualify for this treatment. Whereas the U.S. model generally treats all profits from the rental of ships or aircraft operated in international traffic as qualifying income, the proposed treaty includes in this category income from the rental of ships or aircraft only if the income is derived by an enterprise that operates ships or aircraft in international traffic and only if the rental is incidental to any activity directly connected with such transportation.

Moreover, the U.S. model treats the profits of a resident of one of the countries from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) used in international traffic as taxable only in that country. On the other hand, the proposed treaty provides such treatment only if the containers are used in connection with the operation by the lessor of ships or aircraft in international traffic. If the containers are not so used, the proposed treaty treats the resulting profits as royalty income.

(11) With respect to the article dealing with associated enterprises or related persons, the proposed treaty omits the U.S. model treaty provision stating that the treaty is not intended to limit any law in either country which permits the distribution, apportionment, or allocation of income, deductions, credits, or allowances between non-independent persons when necessary to prevent evasion of taxes or to clearly reflect the income of those persons. Such a provision generally clarifies that the United States retains the right to apply its inter-company pricing rules (Code sec. 482) and its rules relating to the allocation of deductions (Code secs. 861, 862, and 863, and applicable regulations). However, the Treasury Department has made it clear that the United States retains the right under the proposed treaty to apply its inter-company pricing rules, including the "commensurate with income" standard for arm's-length pricing, notwithstanding the omission of the provision.

(12) The U.S. model treaty and many U.S. income tax treaties generally limit to five and 15 percent, respectively, the rates of source country tax on gross dividends paid to "direct" investors (that is, substantial corporate investors) and "portfolio" investors (that is, investors other than direct investors) resident in the other country. By contrast, the proposed treaty allows source country tax at the rates of 15 and 25 percent, respectively, on dividends paid to direct investors and to portfolio investors resident in the other country. Some U.S. income tax treaties contain similar dividend withholding rates for direct investors.

(13) The proposed treaty permits tax to be imposed at the withholding rate of 25 percent on dividends paid by a Regulated Investment Company (RIC) regardless of whether the RIC dividends are paid to a direct or portfolio investor. The proposed treaty permits unrestricted U.S. withholding tax on dividends paid by a real estate investment trust (REIT), unless the dividend is beneficially owned by an individual Indian resident holding a less-than-10-percent interest in the REIT. The Senate recently gave advice and consent to protocols with France and Belgium on the understanding that provisions be negotiated with those countries permitting withholding rates on RIC and REIT dividends higher than the rates provided for in general by the U.S. treaties with those countries.

(14) The proposed treaty generally limits the tax at source on gross interest to 15 percent; interest paid to a bank or other financial institution is subject to tax at the rate of 10 percent. Interest income of the Governments of the countries (including political subdivisions), or others on certain government-related or government-approved debt claims, is exempt from source country tax. Under the U.S. model, by contrast, interest is generally exempt from source country withholding tax. The U.S. model position often is not achieved in treaties with developing countries.

Indian residents generally will receive U.S. source interest on portfolio indebtedness free of U.S. tax in any event, because of the repeal in 1984 of the U.S. gross withholding tax on interest paid on portfolio indebtedness held by foreign persons. However, U.S. residents generally are subject to Indian tax (limited to 15 or 10 percent under the treaty) on Indian source interest on similar indebtedness.

(15) The proposed treaty generally limits the tax at source on gross royalties to 15 percent in the case of royalties in respect of intellectual or intangible property, including movie royalties, and 10 percent in the case of royalties in respect of industrial, commercial, or scientific equipment. Royalties paid by a private party that would be subject to the 15-percent rate are subject to a temporary 20-percent rate for a period of 5 years. The U.S. model exempts royalties from source country tax.

(16) The proposed treaty provides treatment of certain "fees for included services" similar to the treatment of royalties. (See discussion under "Issues," Part II, following.)

(17) The proposed treaty permits each country to tax capital gains in accordance with the provisions of its own domestic laws, except for gains that are exempt under the Shipping and Air Transport article of the proposed treaty. The U.S. model treaty, on the other hand, permits only limited source country taxation of capital gains.

(18) The proposed treaty generally allows imposition of the U.S. branch-level profits and interest taxes. The proposed treaty permits India to impose a corresponding tax burden on Indian permanent establishments of U.S. corporations. The proposed treaty expressly prohibits the imposition of second-level withholding taxes on dividends paid by corporations resident in the other treaty country.

(19) The proposed treaty allows source country taxation of independent personal services income if the worker is present in the source country for more than 90 days in a taxable year. Under the U.S. model, independent personal services income of a nonresident is taxable only if the nonresident has available a fixed base in the source country. This provision in the proposed treaty is also found in the United Nations model treaty and in other U.S. treaties with developing countries.

(20) Compensation derived as a member of the crew of a ship or aircraft operated in international traffic by an enterprise of the United States or India may be taxed in that country. This treatment is unlike that in the U.S. model treaty which permits tax only by a crew member's residence country, but similar to the OECD and the United Nations model treaties.

(21) The proposed treaty, like the OECD model treaty, allows directors' fees derived by a resident of one country, in the individual's capacity as a member of the board of directors of a company which is a resident of the other country, to be taxed in that other country if the fees are for services rendered in that other country. The U.S. model treaty, on the other hand, generally treats directors' fees as personal service income. Under the U.S. model treaty (and the proposed treaty), the country where the recipient resides generally has primary taxing jurisdiction over personal service income.

(22) Under the proposed treaty, source country taxation of income derived by entertainers and athletes from their activities as such is permitted if the income exceeds $1,500 in a taxable year.

The competent authorities of the countries may agree to increase the threshold in order to reflect economic or monetary developments. Under the U.S. model treaty, entertainers and athletes may not be taxed in the source country unless they earn more than $20,000 there during a taxable year. Many U.S. income tax treaties follow the U.S. model approach, although with a lower annual income threshold for taxation than the U.S. model contains. The OECD model treaty permits source country taxation of entertainers and athletes with no annual income threshold.

(23) The proposed treaty permits pensions paid by, or out of funds created by, a country or one of its political subdivisions or local authorities to an individual for services rendered to that country (or subdivision or authority) to be taxable generally only in that country. However, such pensions are taxable only in the other country if the individual is both a resident and a citizen of that other country. The U.S. model treaty allows exclusive taxing jurisdiction to the paying country in the case of payments to one of its citizens, but otherwise does not modify the usual treaty provisions applicable to nongovernmental payments. The provision in the proposed treaty follows the corresponding provision in the OECD and United Nations model treaties.

(24) Under the proposed treaty, a student or apprentice from one country who is studying in the other country is exempt from tax in the host country on payments received from outside the host country for education and maintenance. In the case of nonexempt income from grants, scholarships and employment, the student or apprentice is also allowed certain tax benefits available to host-country residents. The U.S. and OECD model treaties provide narrower relief.

(25) The proposed treaty also provides a host-country tax exemption for visiting professors, teachers, and research scholars. The exemption is available only if the visit does not exceed two years, and applies to research, only if the research is conducted in the public interest. This exemption is found in several U.S. tax treaties, but not in the U.S. model treaty.

(26) The proposed treaty allows each country to tax any income not otherwise specifically dealt with under the treaty that arises from sources in that country or is attributalbe to a permanent establishment or fixed base in that country. This rule applies even if the country of residence does not tax the income. The U.S. model treaty, by contrast, gives the residence country the sole right to tax income not otherwise specifically dealt with under the treaty, regardless of the source of the income, unless the income is attributable to a permanent establishment or a fixed base in the other country. The rule of the proposed treaty is contained in the United Nations model treaty and in a number of existing U.S. income tax treaties.

(27) The proposed treaty contains a limitation on benefits (anti-treaty shopping) article similar to the limitation on benefits articles contained in recent U.S. treaties and protocols and in the branch tax provisions of the Code.

(28) Income derived by a resident of one country that may be taxed in the other country under the proposed treaty is deemed to arise in that other country for purposes of the double taxation

relief article of the proposed treaty. However, any statutory source rules that apply for the purpose of limiting the foreign tax credit generally take precedence over this source rule in determining the applicable relief from double taxation under the proposed treaty.

(29) The scope of the nondiscrimination article in the proposed treaty is limited to the taxes that are covered by the agreement (i.e., national-level income taxes). In this respect the proposed treaty's protection is narrower than that provided in the U.S. model treaty, which applies to all national, state, and local taxes.

(30) The proposed treaty generally requires persons seeking competent authority relief (under the mutual agreement procedure) to apply to the country of which they are residents or nationals within three years of the receipt of notice of the action resulting in taxation not in accordance with the treaty. Although no time limit is imposed in the U.S. model treaty, the three-year limit is consistent with the OECD and United Nations models.

(31) The proposed treaty's exchange of information provision generally follows that of the U.S. model, with some modifications based on the OECD and United Nations models. The U.S. model treaty provides that each country is to endeavor to collect taxes for the other country to the extent necessary to ensure that the treaty does not benefit persons not entitled to treaty benefits. The proposed treaty does not contain this collection assistance rule. The proposed treaty provides for routine exchange of information, as well as information exchange on request. The proposed treaty also contains a statement, not found in the U.S. model, that the competent authorities will develop conditions, methods, and techniques concerning the matters in respect of which information will be exchanged.

II. ISSUES

The proposed treaty, as amended by the proposed protocol, presents the following specific issues.

(1) Treaty shopping

The proposed treaty, like a number of U.S. income tax treaties, generally limits treaty benefits for treaty country residents so that only those residents with a sufficient nexus to a treaty country receive treaty benefits. Although the proposed treaty is intended to benefit residents of India and the United States only, residents of third countries sometimes attempt to use a treaty to obtain treaty benefits. This is known as treaty shopping. Investors from countries which do not have tax treaties with the United States, or from countries which have not agreed in their tax treaties with the United States to limit source country taxation to the same extent that it is limited in another treaty may, for example, attempt to secure a lower rate of tax by lending money to a U.S. person indirectly through a country whose treaty with the United States provides for a lower rate. The third-country investor may do this by establishing a subsidiary, trust, or other investing entity in that treaty country which then makes the loan to the U.S. person and claims the treaty reduction for the interest it receives.

The anti-treaty shopping provision of the proposed treaty is similar to an anti-treaty shopping provision in the Internal Revenue Code (as interpreted by Treasury regulations) and in several newer treaties, including the treaties that are the subject of this hearing. Some aspects of the provision, however, differ either from the anti-treaty shopping provision of the U.S. model or from the anti-treaty shopping provisions sought by the United States in some treaty negotiations since the model was published in 1981. The issue is whether the anti-treaty shopping provision of the treaty effectively forestalls potential treaty shopping abuses.

One provision of the anti-treaty shopping article of the proposed treaty is more lenient than the comparable rule in the U.S. model and certain other U.S. treaties. The U.S. model allows benefits to be denied if 75 percent or less of a resident company's stock is held by individual residents of the country of residence, while the proposed treaty (like several newer treaties and an anti-treaty shopping provision in the Internal Revenue Code) lowers the qualifying percentage to 50 and broadens the class of qualifying shareholders to include residents of either treaty country (and citizens of the United States). Thus, it is considerably easier to fall within the rule in the proposed treaty. On the other hand, counting for this purpose shareholders who are residents of either treaty country would not appear to invite the type of abuse at which the provision is aimed, because the targeted abuse is ownership by third-country residents attempting to obtain treaty benefits.

Another provision of the anti-treaty shopping article differs from the corresponding rule of the U.S. model, but the effect of the difference is less clear. The general test applied by the U.S. model to deny benefits is a broadly subjective one, looking to whether the acquisition, maintenance, or operation of an entity has "as a principal purpose obtaining benefits under" the treaty. By contrast, the proposed treaty contains a more precise test that allows denial of benefits only with respect to income not derived in connection with the active conduct of a trade or business. However, this active trade or business test does not apply with respect to a business of making or managing investments, other than a bona fide banking or insurance business, so benefits can be denied with respect to an investment business regardless of how actively it is conducted. In addition, the proposed treaty gives the competent authorities the ability to override this standard.

The practical difference between the proposed treaty tests and the U.S. model test will depend upon how they are interpreted and applied. The principal purpose test may be applied leniently (so that any colorable business purpose suffices to preserve treaty benefits), or it may be applied strictly (so that any significant intent to obtain treaty benefits suffices to deny them). Similarly, the standard in the proposed treaty could be interpreted to require, for example, a more active or a less active trade or business (though the range of interpretation is far narrower). Thus, a narrow reading of the principal purpose test could theoretically be stricter than a broad reading of the proposed treaty test (i.e., would operate to deny benefits in potentially abusive situations more often).

The United States should maintain its policy of limiting treaty-shopping opportunities whenever possible, and in exercising any latitude the Treasury Department has to adjust the operation of the limitation, it should satisfy itself that its rules adequately deter treaty-shopping abuses. Further, the proposed anti-treaty shopping provision may be effective in preventing third-country investors from obtaining treaty benefits by establishing investing entities in India, inasmuch as third-country investors may be unwilling to share ownership of such investing entities on a 50-50 basis with U.S. or Indian residents or other qualified owners to meet the ownership test of the anti-treaty shopping provision. The base erosion test, which limits the ability of a treaty-country entity to shift its income to persons that are not treaty-country residents, provides protection from the potential abuse of an Indian conduit. Finally, India imposes significant taxes of its own and retains high source taxes in its treaties on payments to third-country residents; these taxes may deter third-country investors from seeking to use Indian entities to make U.S. investments. The Committee should satisfy itself that the provision as proposed is an adequate tool for preventing possible treaty-shopping abuses.

(2) Developing country concessions

The proposed treaty contains a number of developing country concessions, some of which are found in other U.S. income tax treaties with developing countries. The most important of these concessions are listed below.

Definition of permanent establishment

The proposed treaty departs from the U.S. and OECD model treaties by providing for relatively broad source-basis taxation. The proposed treaty's permanent establishment article, for example, permits the country in which business activities are carried on to tax the activities sooner, in certain cases, than it would be able to under either of the model treaties. Under the proposed treaty, a building site or construction or assembly or installation project (or supervisory activities related to such projects) creates a permanent establishment if it exists in a country for more than 120 days; under the U.S. model, a building site, etc., must last for at least one year. Thus, for example, under the proposed treaty, business profits attributable to an installation project in India are taxable by India if the project lasts for more than 120 days. Similarly, under the proposed treaty, the use of a drilling rig in a country for more than 120 days creates a permanent establishment there; under the U.S. model, drilling rigs must be present in a country for at least one year. Most tax treaties between the United States and developing countries provide a permanent establishment threshold of six months for building sites and drilling rigs.

Moreover, the proposed treaty contains a 90-day permanent establishment threshold with respect to the furnishing of certain services in one of the countries. Although the U.S. model is silent with respect to the determination of a permanent establishment in cases involving services, the preferred treaty position of the United States in conventions with developing countries has been a minimum of 183 days.

In addition, an independent agent of an enterprise may constitute a permanent establishment of that enterprise under the proposed treaty if the agent's activities are devoted wholly or almost wholly on behalf of that enterprise and the transactions between the agent and the enterprise are not made under arm's-length conditions. The U.S. model treaty does not contain this rule, although it is contained in some U.S. treaties with developing countries.

Treatment of fees for included services

The proposed treaty treats in the same manner as royalties certain "fees for included services." Fees for included services are defined (in paragraph 4 of Article 12) generally to mean payments of any kind to any person in consideration for the rendering of any technical or consultancy services (including through the provision of services of technical or other personnel) if such services either (a) are ancillary and subsidiary to the application or enjoyment of the right, property, or information for which a royalty payment is received; or (b) make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design. (Clarifications to the definition of fees for included services, and understandings regarding the scope of included services, are discussed at length in Part IV, "Explanation of the Proposed Tax Treaty.")

The treatment of service fees provided in the proposed treaty is a departure from the domestic law of both the United States and India. Staff is informed that under Indian statutory law, a broad range of service fees (fees for technical, managerial, or consultancy services performed anywhere) is subject to a 30-percent gross basis tax if paid by an Indian resident. The proposed treaty both narrows the range of service fees subject to gross basis taxation and reduces the applicable tax rate. Under U.S. statutory law, fees for services performed inside the United States are subject to tax on a net basis if effectively connected with a U.S. trade or business of a nonresident alien or foreign corporation or on a gross basis (at the rate of 30 percent) only if not effectively connected. Paragraph IV of the proposed protocol (Ad Article 12) clarifies that, if fees for included services may be taxed by the United States under Article 12 but are subject to net basis tax under internal U.S. law, the level of that net basis taxation (or, where applicable, the sum of that net basis tax and the amount of the tax allowable under paragraph 1 of Article 14 (Permanent Establishment Tax) with respect to those fees) is not to exceed the gross basis tax at the limited rates imposed under Article 12. The term "fees for included services" is not defined (apart from the proposed treaty) in the domestic laws of either country.

The proposed treaty treats these service fees for foreign tax credit purposes as derived from sources in the country permitted to impose a gross-basis tax under Article 12, regardless of where the activities giving rise to the income take place. Unlike the treaty's source rule that applies to other types of income for foreign tax credit purposes, this source rule does not yield to conflicting statutory source rules that apply for foreign tax credit purposes. Thus, in the case of a U.S. taxpayer earning service fees that are subject to Indian gross-basis tax under Article 12 for services conducted in the United States, the taxpayer's foreign source income for foreign tax credit limitation purposes will be increased by the amount of such fees.

Despite the fact that the treatment of fees for included services under the proposed treaty represents a significant concession from Indian statutory law that is unique to date, that treatment also constitutes a ceding by the United States of tax jurisdiction of unprecedented scope in U.S. tax treaties, over income of a U.S. person that is treated as U.S. source under the Code. It generally is not U.S. treaty policy to cede tax jurisdiction, by allowing a foreign tax credit, over royalty or fee income of a U.S. person that is treated as U.S. source under the Code (although, for example, the treaty with Australia provides a royalty source rule that differs significantly from the Code and also applies for foreign tax credit purposes). Inasmuch as the included services under the proposed treaty are all related to the use or transfer of specialized skill or proprietary knowledge or information, source country taxation of fees for included services can be expected to be imposed primarily by India rather than by the United States.

Source basis taxation

Additional concessions to source basis taxation in the proposed treaty include a maximum rate of source country tax on interest that is higher than that provided in the U.S. model treaty; a maximum rate of source country tax on dividends that is higher than that provided in the U.S. model treaty; taxing jurisdiction on the part of the source country as well as the residence country with respect to income not otherwise specifically dealt with by the proposed treaty; and broader source country taxation of personal services income (especially directors' fees), capital gains and entertainers' income than that allowed by the U.S. model.

Taxation of business profits

Under the U.S. model and many other U.S. income tax treaties, a country may tax only the business profits of a resident of the other country to the extent those profits are attributable to a permanent establishment situated within the first country. The proposed treaty expands the definition of business profits beyond the traditional definition to include profits that are derived from sources within the country where a permanent establishment exists from (a) sales of goods or merchandise of the same or similar kind as those sold through the permanent establishment, or (b) other business activities of the same or similar kind as those effected through the permanent establishment. This expanded definition follows the United Nations model treaty. It should be noted that although this rule provides for broader source basis taxation than does the rule contained in the U.S. model, it is less broad in some respects than the general "force of attraction" rule of Code section 864(c)(3).

Also following the United Nations model treaty is a rule in the proposed treaty that limits certain deductions for expenses incurred on behalf of a permanent establishment by the enterprise's head office.

Certain equipment leasing

In addition to containing the traditional definition of royalties which is found in most U.S. tax treaties (including the U.S. model), the proposed treaty provides that royalties include payments for the use of, or the right to use, industrial, commercial, or scientific equipment. These payments are often considered rentals by other treaties, subject to business profits rules which generally permit the source country to tax such profits only if they are attributable to a permanent establishment located in that country, and in such case, the tax is computed on a net basis. By contrast, the proposed treaty permits gross-basis source country taxation of these payments, at a rate not to exceed 10 percent, if the payments are not attributable to a permanent establishment situated in that country.[2]

Issue presented

One purpose of the proposed treaty is to reduce tax barriers to direct investment by U.S. firms in India. The practical effect of these developing country concessions could be greater Indian taxation of future activities of U.S. firms in India than would be the case under the rules of either the U.S. or OECD model treaties.

The issue is whether the developing country concessions are appropriate U.S. treaty policy and, if so, whether India is an appropriate recipient of these concessions. There is a risk that the inclusion of these concessions in the proposed treaty could result in additional pressure on the United States to include them in future treaties negotiated with other developing countries. Conversely, the fact that the proposed treaty does not provide tax-sparing benefits may strengthen the ability of the United States to negotiate treaties with other developing countries without making that undesirable concession. A number of existing U.S. treaties with developing countries already include developing country concessions. Such concessions are arguably necessary in order to obtain treaties with developing countries such as India. Tax treaties with developing countries can be in the interest of the United States because they provide developing country tax relief for U.S. investors and a clearer framework within which the taxation of U.S. investors will take place.

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[2] If the payments are attributable to such a permanent establishment, then the business profits article of the proposed treaty applies.

(3) Treatment of income from container leasing

For the most part, the article of the proposed treaty dealing with shipping and air transport follows closely the corresponding article of the U.S. model in that residents of one country generally are exempt from taxation by the other country on income derived from the operation of ships or aircraft in international traffic. The proposed treaty does not include in the shipping exemption certain income from the use or maintenance of containers ("container leasing income"). Instead, it treats such income as rental income under the royalty article. Specifically excluded from the definition of shipping income is income from the use or maintenance of containers and related equipment for the transportation of containers, unless the containers and equipment are used in connection with the operation of ships of aircraft in international traffic. Thus, for example, a U.S. company that operates ships or aircraft in international traffic, and in connection with that operation uses containers, is not taxed by India on the income earned in those operations even though a portion of that income is generated by use of the containers. By contrast, a U.S. company whose sole operation involves the leasing of containers used in international transport is not granted the same exemption. Income from such operations is treated as royalty income under the proposed treaty, and to the extent that it is sourced in India may be subject to a gross basis withholding tax in India at a rate of up to 10 percent.

This special rule regarding container leasing income differs from the provision of the U.S. model which treats income from container leasing as transportation income, generally taxable only by the residence country. Under the OECD model treaty, container leasing income (along with income from the rental of other equipment) is treated as royalty income which is exempt from taxation in the source country. Similarly, the United Nations model treaty treats such income as royalty income, but does not specify the rate of tax (if any) applicable to royalties in the source country. In addition, the OECD subsequently published a view that container leasing income should be treated as ordinary business profits, which would be exempt from taxation in the source country in the absence of a permanent establishment.[3]

Rules regarding container leasing income similar to the provisions contained in the proposed treaty are included in two current U.S. income tax treaties: the treaties with Australia and New Zealand. Although the Senate Foreign Relations Committee approved both of these treaties in 1983, it did so despite making specific mention of its serious concern regarding the container leasing provisions. In fact, the Committee advised the Treasury Department, in any future negotiations, to take all necessary steps to conform future treaties to the U.S. model on this issue.

In 1983 the Committee expressed concern that by departing from the U.S. model on this issue, members of the U.S. container leasing industry were adversely affected. It specified a number of reasons why such a departure was of concern, some of which appear to be equally applicable to the provision contained in the proposed treaty. First, permitting source country taxation of container leasing income represents a significant departure from U.S. treaty policy as expressed in the U.S. model treaty and from general U.S. practice. Second, inclusion of this provision seems to indicate that there is some justifiable distinction between container leasing income and other transportation income, although at the time the Committee considered the Australian and New Zealand proposed treaties, it did not believe that any such justifiable distinction existed. Third, this provision allows the source country to impose a gross withholding tax that might exceed net income in certain cases. Fourth, the 1983 committee report states that the provision places container leasing companies at a competitive disadvantage vis-a-vis shipping companies who lease containers in international traffic as an incidental part of their business, and who are exempt from source country tax on those container leases under the proposed treaty.

It is understood that under present Indian tax law, India does not impose a gross basis withholding tax on container leasing income from sources in India. Rather, India imposes a high-rate tax on business profits, including container leasing income, on a basis that permits some deductions from gross income. Therefore, the proposed treaty permits India to impose its current tax, although at a rate that may be limited, on a substantial class of container leasing income that would be exempt from source taxation under the U.S. model treaty.

(4) Insurance excise tax

The proposed treaty covers (i.e., waives) the U.S. excise tax on insurance premiums paid to foreign insurers. Thus, for example, an Indian insurer or reinsurer without a permanent establishment in the United States can collect premiums on policies covering a U.S. risk or a U.S. person free of this tax. However, the tax is imposed to the extent that the risk is reinsured by the Indian insurer or reinsurer with a person not entitled to the benefits of the proposed treaty or another treaty providing exemption from the tax. This latter rule is known as the "anti-conduit" clause.

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[3] Committee on Fiscal Affairs, OECD, *The Taxation of Income Derived From the Leasing of Containers* para. 15 (1985).

Recent waivers of the excise tax have raised serious Congressional concerns. For example, concern has been expressed over the possibility that they may place U.S. insurers at a competitive disadvantage to foreign competitors in U.S. markets, if insubstantial tax is imposed by the other country to the treaty (or any other country) on the insurance income of its residents (or the income of companies with which they reinsure their risks). Moreover, in such a case waiver of the tax does not serve the purpose of treaties to avoid double taxation, but instead has the undesirable effect of eliminating all taxation.

The U.S.-Barbados and U.S.-Bermuda tax treaties each contained such a waiver as originally signed. In its report on the Bermuda treaty, the Committee on Foreign Relations expressed the view that those waivers should not have been included. The Committee stated that future waivers should not given by Treasury in its future treaty negotiations without prior consultations with the appropriate committees of Congress. In addition, the waiver of the tax in the treaty with the United Kingdom (where the tax was waived without the "anti-conduit" clause) has been followed by a number of legislative efforts to redress a perceived competitive imbalance created by the waiver.

The proposed treaty waives imposition of the excise tax on premiums paid to residents of India. Unlike Bermuda and Barbados, India imposes substantial tax on income, including insurance income, of its residents. In addition, it is understood that the Indian insurance industry is nationalized and is subject to significant regulatory control. Unlike the U.K. waiver, moreover, the Indian treaty waiver contains the standard anti-conduit language. The Committee may wish to assure itself that the practical effect of the waiver of the tax in this treaty is in fact to reduce double taxation, rather then to give Indian insurers competing in the U.S. market a significantly more favorable overall tax burden than their U.S. counterparts.

(5) Exchange of information

The exchange of information article contained in the proposed treaty differs, in some respects, from the corresponding articles of the OECD and U.S. model treaties. The primary difference between the U.S. model and the proposed treaty (and OECD model) is that the U.S. model contains a clause that requires each treaty country to assist in the collection of taxes to the extent necessary to ensure that treaty benefits provided by the other country are enjoyed only by persons entitled to those benefits under the treaty. In providing such assistance, the U.S. model does not impose on the other country an obligation to carry out administrative measures that are at variance with its internal measures for tax collection, or that are contrary to its sovereignty, security, or public policy. Assistance in collection can be useful, for example, in a case where an entity located in a country with which the United States has a treaty serves as a nominee for a third-country resident. If the entity, on behalf of the third-country resident, receives a dividend from a U.S. corporation with respect to which a reduced rate of tax (as provided for by the treaty) is inappropriately withheld, the entity, as a withholding agent, is technically liable to the United States for the underpaid amount of tax. However, without assistance from the government of the treaty country in which the entity is resident, enforcement of that liability may be difficult.

The issue is whether the Committee views the exchange of information rules contained in the proposed treaty as sufficient to carry out the tax-avoidance purpose for which income tax treaties are entered into by the United States. With respect to the absence of a reciprocal tax collection provision, the Committee may wish to consider the extent to which absence of such a provision adversely affects U.S. efforts to confine Indian treaty benefits to persons entitled to those benefits. Absence of collection assistance in this treaty also may decrease the United States's ability to obtain the desired level of collection assistane in treaty negotiations with other countries.

III. OVERVIEW OF UNITED STATES TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES

This overview contains two parts. The first part describes the U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. The second part discusses the objectives of U.S. tax treaties and describes some of the modifications they make in U.S. tax rules.

A. United States Tax Rules

The United States taxes U.S. citizens, U.S. residents, and U.S. corporations on their worldwide income. The United States taxes nonresident alien individuals and foreign corporations on their U.S. source income that is not effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "noneffectively connected income"). Nonresident alien individuals and foreign corporations are also taxed on their U.S. source income and certain limited classes of foreign source income that is effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "effectively connected income").

Income of a nonresident alien or foreign corporation that is effectively connected with the conduct of a trade or business in the United States is subject to tax at the normal graduated rates on the basis of net taxable income. Deductions are allowed in computing effectively connected taxable income, but only if and to the extent that they are related to income that is effectively connected. A foreign corporation is also subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the U.S. effectively connected earnings of the corporation that are removed in any year from the conduct of its U.S. trade or business. A foreign corporation is also subject to a branch level interest tax, which amounts to a flat 30 percent of the interest deducted by the foreign corporation in computing its U.S. effectively connected income but not paid by the U.S. trade or business.

U.S. source fixed or determinable annual or periodical income of a nonresident alien or foreign corporation (generally including interest, dividends, rents, salaries, wages, premiums, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to tax at a rate of 30 percent of the gross amount paid. In the case of certain insurance premiums earned by such a person, the tax is 1 or 4 percent of the premium paid. These taxes generally are collected by means of withholding (hence these taxes are often called withholding taxes).

These taxes are often reduced or eliminated in the case of payments to residents of countries with which the United States has an income tax treaty. In addition, certain exemptions from the 30-percent tax are provided. For example, interest on deposits with banks or savings institutions is exempt from tax unless such interest is effectively connected with the conduct of a U.S. trade or business. Exemptions are provided for certain original issue discount and for income of a foreign government or international organization from investments in U.S. securities. Additionally, certain interest paid on portfolio obligations is exempt from the 30-percent tax. U.S. treaties also provide for exemption from tax in certain cases.[4]

U.S. source noneffectively connected capital gains of nonresident alien individuals and foreign corporations are generally exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the sale of interests in U.S. real estate.[5]

The source of income received by nonresident aliens and foreign corporations is determined under rules contained in the Internal Revenue Code. Interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation are generally considered U.S. source income. Interest paid by the U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation. However, if during a three-year testing period a U.S. corporation or U.S. resident alien individual derives more than 80 percent of its gross income from the active conduct of a trade or business in a foreign country or possession of the United States, then interest paid by that person is foreign source rather than U.S. source. Moreover, even though dividends paid by a corporation meeting this test (an "80/20" company) are U.S. source, a fraction of each dividend corresponding to the foreign source fraction of the corporation's income for the three-year period are not subject to U.S. withholding tax. Conversely, dividends and interest paid by a foreign corporation are generally treated as foreign source income. However, in the case of a dividend paid by a foreign corporation, 25 percent or more of whose gross income over a three-year testing period consists of income that is treated as effectively connected with the conduct of a U.S. trade or business, a portion of such dividend is considered U.S. source income. The U.S. source portion of such dividend is generally equal to the total amount of the dividend, multiplied by the ratio over the testing period of the foreign corporation's U.S. effectively connected gross income to total gross income. (No tax is imposed, however, on a foreign recipient to the extent of such U.S. source portion unless a treaty prevents application of the statutory branch profits tax.)

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[4] Where the Code or treaties eliminate tax on interest paid by a corporation to certain related persons, the Code generally provides for denial of interest deductions at the corporate level to the extent that its net interest expenses exceed 50 percent of adjusted taxable income. The amount of the disallowance is limited however, by the amount of tax-exempt interest paid to related persons.

[5] In addition, bills have been introduced in Congress that would tax as effectively connected income gains derived by foreign persons from the sale of stock of domestic corporations in cases where the foreign person held at least a threshold amount (i.e., 10 percent) of the stock of the domestic corporation (H.R. 3299, sec. 11404, 101st Cong., 1st Sess. (1989); H.R. 4308, sec. 201, 101st Cong., 2d Sess. (1990); S. 2410, sec. 201, 101st Cong., 2d Sess. (1990)).

Rents and royalties paid for the use of property in the United States are considered U.S. source income. The property used can be either tangible property or intangible property (e.g., patents, secret processes and formulas, franchises and other like property).

Because the United States taxes U.S. persons on their worldwide income, double taxation of income can arise in that income earned abroad by a U.S. person may be taxed both by the country in which the income is earned and by the United States. The United States seeks to mitigate this double taxation by generally allowing U.S. persons to credit their foreign income taxes against the U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign source income. The foreign tax credit limitation generally is computed on a worldwide consolidated (overall) basis. Pursuant to rules enacted as part of the 1986 Act, the overall limitation is computed separately for certain classifications of income (e.g., passive income, high withholding tax interest, financial services income, shipping income, dividends from noncontrolled section 902 corporations, DISC dividends, FSC dividends, and taxable income of a FSC attributable to foreign trade income) in order to prevent the averaging of foreign taxes on certain types of traditionally high-taxed foreign source income against the U.S. tax on certain items of traditionally low-taxed foreign source income. Also, a special limitation applies to the credit for foreign taxes imposed on oil and gas extraction income.

Prior to the Tax Reform Act of 1984 (the "1984 Act"), a U.S. person could convert U.S. source income to foreign source income, thereby circumventing the foreign tax credit limitation, by routing the income through a foreign corporation. The 1984 Act added to the foreign tax credit provisions special rules that prevent U.S. persons from converting U.S. source income into foreign source income through the use of an intermediate foreign payee. These rules apply only to 50-percent U.S.-owned foreign corporations. In order to prevent a similar technique from being used to average foreign taxes among the separate limitation categories, the 1986 Act provided lookthrough rules for the characterization of inclusions and income items received from a controlled foreign corporation.

Prior to the 1986 Act, a U.S. taxpayer with substantial economic income for a taxable year potentially could avoid all U.S. tax liability for such year so long as it had sufficient foreign tax credits and no domestic taxable income (whether or not the taxpayer had economic income from domestic operations). In order to mandate at least a nominal tax contribution from all U.S. taxpayers with substantial economic income, the 1986 Act provided that foreign tax credits cannot exceed 90 percent of the pre-foreign tax credit tentative minimum tax (determined without regard to the net operating loss deduction). However, as amended by the Omnibus Budget Reconciliation Act of 1989, no such limitation is imposed on a corporation if more than 50 percent of its stock is owned by U.S. persons, all of its operations are in one foreign country with which the United States has an income tax treaty with information exchange provisions, and certain other requirements are met.

For foreign tax credit purposes, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation (or an inclusion of the foreign corporation's income) is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid for the year the dividend is received and go into the relevant pool or pools of separate limitation category taxes to be credited.

B. United States Tax Treaties—In General

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. To a large extent, the treaty provisions designed to carry out these objectives supplement Code provisions having the same objectives; the treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty country. Given the diversity of tax systems, it would be very difficult to develop in the Code rules that unilaterally would achieve these objectives for all countries.

Notwithstanding the unilateral relief measures of the United States and its treaty partners, double taxation might arise because of differences in source rules between the United States and the other country. Likewise, if both countries consider the same deduction allocable to foreign sources, double taxation can result. Problems sometimes arise in the determination of whether a foreign tax qualifies for the U.S. foreign tax credit. Also, double taxation may arise in those limited situations were a corporation or individual may be treated as a resident of both countries and be taxed on a worldwide basis by both.

In addition, there may be significant problems involving "excess" taxation—situations where either country taxes income received by nonresidents at rates that exceed the rates imposed on residents. This is most likely to occur in the case of income taxed at a flat rate on a gross basis. (Most countries, like the United States, generally tax domestic source income on a gross basis when it is received by nonresidents who are not engaged in business in the country.) In many situations the gross income tax exceeds the tax that would have been paid under the net income tax system applicable to residents.

Another related objective of U.S. tax treaties is the removal of barriers to trade, capital flows, and commercial travel caused by overlapping tax jurisdictions and the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal.

The objective of limiting double taxation is generally accomplished in treaties by the agreement of each country to limit, in certain specified situations, its right to tax income earned from its territory by residents of the other country. For the most part, the various rate reductions and exemptions by the source country provided in the treaties are premised on the assumption that the country of residence taxes the income in any event at levels comparable to those imposed by the source country on its residents. The treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes that the source country retains the right to impose under the treaty. In some cases, the treaties may provide for exemption by the residence country of income taxed by the source country pursuant to the treaty.

Treaties first seek to eliminate double taxation by defining the term "resident" so that an individual or corporation generally is not subject to primary taxing jurisdiction as a resident by each of the two countries. Treaties also provide that neither country may tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a branch or other permanent establishment or fixed base. The treaties contain commercial visitation exemptions under which individual residents of one country performing personal services in the other are not required to pay tax in that other country unless their contacts exceed certain specified minimums, for example, presence for a set number of days or earnings of over a certain amount within the taxable year.

Treaties deal with passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country by either providing that they are taxed only in the country of residence or by providing that the source country's withholding tax generally imposed on those payments is reduced. As described above, the United States generally imposes a 30-percent tax and seeks to reduce this tax (on some income to a zero rate) in its tax treaties, in return for reciprocal treatment by its treaty partner.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect, and provides this in the treaties' "saving clause." Double taxation can also still arise because most countries do not exempt passive income from tax at the source.

This double taxation is further mitigated either by granting a credit for income taxes paid to the other country, or, in the case of some U.S. treaty partners, by providing that income is exempt from tax in the country of residence. The United States in its treaties allows a credit against U.S. tax for income taxes paid to the treaty partners, subject to the limitations of U.S. law.

The objective of preventing tax avoidance and evasion is generally accomplished in treaties by the agreement of each country to exchange tax-related information. The treaties generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out the provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information not obtainable under its laws or in the normal course of its administration, or to supply information that would disclose trade secrets or other information the disclosure of which would be contrary to public policy. The provisions generally result in an exchange of routine information, such as the names of U.S. residents receiving investment income. The Internal Revenue Service (and the treaty partner's tax authorities) also can request specific tax information from a treaty partner. This can include information to be used in a criminal investigation or prosecution.

Administrative cooperation between the countries is further assured under the treaties by the inclusion of a competent authority mechanism to resolve double taxation problems arising in individual cases and, more generally, to facilitate consultation between tax officials of the two governments.

At times, residents of countries without income tax treaties with the United States attempt to use a treaty to avoid U.S. tax. To prevent third-country residents from obtaining treaty benefits intended for treaty country residents only, the treaties generally contain an "anti-treaty shopping" provision that is designed to limit treaty benefits to bona fide residents of the two countries.

The treaties generally provide that neither country may subject nationals of the other country (or permanent establishments of enterprises of the other country) to taxation more burdensome than that it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither country may discriminate against its enterprises owned by residents of the other country.

IV. EXPLANATION OF PROPOSED TAX TREATY

A detailed, article-by-article explanation of the proposed income tax treaty between the United States and India (as modified by the proposed protocol and interpreted by the memorandum of understanding and the exchange of notes) is presented below. The proposed protocol is unusual in that its signing occurred at the same time as the signing of the proposed treaty. The proposed treaty and the proposed protocol, upon entry into force, would operate as one document, and it is of no consequence that some provisions appear in the proposed protocol while others appear only in the body of the proposed treaty.

Article 1. General Scope

The general scope article describes the persons who may claim the benefits of the proposed treaty and contains other rules including the "saving clause."

The proposed treaty applies generally to residents of the United States and to residents of India, with specific exceptions designated in other articles. This application follows other U.S. income tax treaties, the U.S. model treaty, and the OECD model treaty. The treaty also applies, in limited cases designated in other articles, to persons who are residents of neither India nor the United States. Article 4 defines the term "resident."

The proposed treaty does not restrict any benefits accorded by the internal laws of, or by any other agreement between, the United States and India. Thus, the treaty applies only where it benefits taxpayers. However, any selective application of the treaty under this provision must be consistent. For example, the permanent establishment threshold for source-country taxation of business profits (Article 7) applies to all business activities conducted in a source country or to no such business activities; the taxpayer may not selectively apply the treaty's permanent establishment threshold to income-generating business activities but apply the lower statutory threshold to loss-generating activities (Rev. Rul. 84-17, 1984-1 C.B. 308). Similarly, when the application of any provision of law takes into account tax attributes of more than one year (e.g., loss carryovers or foreign tax credit carryovers), either statutory rules or treaty rules must be consistently applied to all of the tax attributes involved.

Like all U.S. income tax treaties, the proposed treaty also contains a "saving clause." Under this clause, with specific exceptions described below, each country reserves the right to tax its citizens and residents, notwithstanding any provision of the treaty. By reason of this saving clause, unless otherwise specifically provided in the proposed treaty, the United States continues to tax its citizens who are residents of India as if the treaty were not in force. For purposes of the treaty (and, thus, for purposes of the saving clause) the term "resident" includes corporations and other entities as well as individuals (Article 4).

Under section 877 of the Internal Revenue Code (the "Code"), a former U.S. citizen whose loss of citizenship had as one of its principal purposes the avoidance of U.S. income, estate, or gift taxes, in certain cases, is be subject to tax for a period of 10 years following the loss of citizenship. The treaty contains the standard provision, found in the U.S. model and most recent treaties, specifically reserving to the United States the right to tax former citizens. (However, even absent a specific provision, the Internal Revenue Service has taken the position that the United States retains the right to tax former citizens resident in the treaty partner (Rev. Rul. 79-152, 1979-1 C.B. 237).)

Exceptions to the saving clause are provided for certain benefits conferred by the articles dealing with associated enterprises (Article 9), pensions and child support (Article 20), relief from double taxation (Article 25), nondiscrimination (Article 26), and mutual agreement procedures (Article 27). The benefits in question are conferred by each country on it own citizens and residents as well as the citizens and residents of the other country. In addition, the benefits conferred by the articles dealing with the taxation of income received in respect of government service (Article 19), students and apprentices (Article 21), professors and teachers (Article 22), and diplomatic agents and consular officers (Article 29), are provided by each country to its residents who are neither citizens of, nor have immigrant status in, that country. An individual has immigrant status in the United States who has been admitted to the United States as a permanent resident under U.S. immigration laws (i.e., holds a "green card").

Article 2. Taxes Covered

In the case of the United States, the proposed treaty applies to the Federal income taxes imposed under the Code, other than the accumulated earnings tax, the personal holding company tax, and social security taxes. The proposed treaty also applies to the excise taxes imposed on insurance premiums paid to foreign insurers and with respect to private foundations. The excise taxes imposed on insurance premiums paid to foreign insurers are covered by the treaty only to the extent that the risks covered by the premiums are not reinsured with a person not entitled to benefits under this or another U.S. tax treaty that applies to these excise taxes. Therefore, under the business profits article (Article 7), and other income article (Article 23), income of an Indian insurer from the insurance of U.S. risks is not subject to the insurance excise tax (except if the risk is reinsured with a company not entitled to the exemption) if that insurance income is not attributable to a U.S. permanent establishment maintained by the Indian insurer. Some recent U.S. income tax treaties, for example, the treaties with France and Hungary, also cover the insurance excise tax. It is a covered tax under the U.S. model treaty.

The insurance excise tax applies notwithstanding the proposed treaty if an Indian insurer with no U.S. trade or business reinsures a policy it has written on a U.S. risk with a foreign insurer other than a resident of India or another insurer entitled to exemption under a different tax treaty (such as the U.S.-France treaty). For example, assume an Indian company not engaged in a U.S. trade or business insures a U.S. casualty risk and receives a premium of $200. The company reinsures part of the risk with a Luxembourg insurance company (not currently entitled to exemption from the excise tax) and pays that Luxembourg company a premium of $100. The four-percent excise tax on casualty insurance applies to the premium paid to the Indian insurance company to the extent of the $100 reinsurance premium. Thus, the U.S. insured is liable for an excise tax of $4, which is four percent of the portion of its premium to the Indian insurer which was used by the Indian insurer to reinsure the risk. It is the responsibility of the U.S. insured to determine to what, if any, extent the risk is to be reinsured with a nonexempt person.

In the case of India, the treaty applies to the income tax, including any surcharge thereon but excluding income tax on the undistributed income of companies (imposed under the Income-tax Act), and the surtax.

Additionally, the exchange of information provisions of the treaty (Article 28) apply, in the case of the United States, to all taxes imposed under the Internal Revenue Code (title 26 of the United States Code), and in the case of India, to the income tax, the wealth tax, and the gift tax.

The proposed treaty also contains a provision generally found in U.S. income tax treaties to the effect that it will apply to substantially similar taxes that either country may subsequently impose.

The proposed treaty, like the U.S. model, obligates the competent authority of each country to notify the competent authority of the other country of any significant changes in the tax laws of its country and of any official published material concerning the application of the treaty.

Article 3. General Definitions

The proposed treaty contains certain of the standard definitions found in most U.S. income tax treaties.

The term "India" means the territory of India and its territorial waters, plus any maritime zone area in which, in accordance with international and Indian law, India has sovereign rights, other rights and jurisdictions. Therefore, income earned on the Indian continental shelf is covered.

The term "United States" means the United States of America. When used in a geographic sense, the term means the territory of the United States and its territorial waters, and all other area over which the United States has jurisdiction in accordance with international law and in which the laws relating to U.S. tax are in force. The term does not include Puerto Rico, the Virgin Islands, Guam, or any other U.S. possession or territory. The definition is intended to cover the U.S. continental shelf.

The term "person" is defined to include an individual, an estate, a trust, a partnership, a company, and any other body of persons. A "company" is any body corporate or any other entity which is treated as a body corporate for tax purposes.

An enterprise of a country is defined as an enterprise carried on by a resident of that country. Although the treaty does not define the term "enterprise," it is understood to have the same meaning that it has in other U.S. tax treaties—the trade or business activities undertaken by an individual, company, partnership, or other entity.

The U.S. competent authority is the Secretary of the Treasury or his delegate. In fact, the U.S. competent authority function has been delegated to the Commissioner of Internal Revenue, who has redelegated the authority to the Assistant Commissioner (International). With respect to interpretative issues, the Assistant Commissioner (International) acts with the concurrence of the Associate Chief Counsel (International) of the Internal Revenue Service.

The Indian competent authority is the Central Government in the Ministry of Finance (Department of Revenue), or their authorized representative.

The term "national" is defined to mean any individual who is a citizen or national of the United States or India.

The proposed treaty defines "international traffic" as any transport by a ship or aircraft operated by an enterprise of one country, except if the transport is operated solely between places in the other country. Accordingly, with respect to an Indian enterprise, purely domestic transport within the United States (if such transport were permitted under U.S. law) is excluded.

The term "taxable year" is defined in the proposed treaty with regard to Indian tax as the "previous year," as that term is defined in India's 1961 Income-tax Act. With regard to U.S. tax, the term "taxable year" is defined in Code section 7701(a)(23), rather than in the proposed treaty.

The proposed treaty also contains the standard provision that, unless the context otherwise requires or the competent authorities of the two countries agree to a common meaning, any term not defined in the treaty is to have the meaning which it has under the applicable tax laws of the country applying the treaty.

Article 4. Residence

The assignment of a country of residence is important because the benefits of the proposed treaty generally are available only to a resident of one of the countries as that term is defined in the treaty. Furthermore, double taxation is often avoided by the treaty assigning one of the countries as the country of residence if, under the laws of the two countries, a person is a resident of both.

Under U.S. law, residence of an individual is important because a resident alien is taxed on the individual's worldwide income, while a nonresident alien is taxed only on the individual's U.S. source income and on the individual's income that is effectively connected with a U.S. trade or business. A company is a resident of the United States if it is organized in the United States. An individual who spends substantial time in the United States in any year or over a three-year period generally is a U.S. resident (Code sec. 7701(b)). A permanent resident for immigration purposes also is a U.S. resident. The standards for determining residence under the Code do not apply in determining the residence of a U.S. citizen for the purpose of any U.S. tax treaty (such as a treaty that benefits residents, rather than citizens, of the United States).

The proposed treaty generally defines a "resident" of a country to mean any person who, under the laws of that country, is subject to tax therein by reason of domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature. However, the term "resident" of a country does not include any person who is subject to tax in that country in respect only of income from sources in that country.

This provision of the proposed treaty is generally based on the fiscal domicile article of the U.S. model and OECD model tax treaties and is similar to the provisions found in other U.S. tax treaties. Consistent with the U.S. model tax treaty, but unlike the OECD model and most U.S. income tax treaties, citizenship alone *does* establish residence. As a result, U.S. citizens residing overseas (in countries other than India) are entitled to the benefits of the treaty as U.S. residents. This provision is achieved in very few treaties.

Moreover, in the case of income derived or paid by a partnership, an estate, or trust, the term "resident" of a country applies only to the extent that the income derived by the partnership, estate, or trust is subject to tax in that country as the income of a resident, either in its hands or in the hands of its partners or beneficiaries. For example, if the share of U.S. residents in the profits of a U.S. partnership is only one-half, India would have to reduce its withholding tax on only half of the Indian source income paid to the partnership.

The proposed treaty provides a set of "tie-breaker" rules to determine residence in the case of an individual who, under the basic treaty definition, is a resident of both countries. These rules are identical to the corresponding rules in the U.S. model treaty. Such a dual resident individual is deemed to be a resident of the country in which he or she has a permanent home available. If this permanent home test is inconclusive because the individual has a permanent home in both countries, the individual's residence is deemed to be the country with which the individual's personal and economic relations are closer, i.e., the individual's "center of vital interests." If the country of the individual's center of vital interests cannot be determined, or if the individual does not have a permanent home available in either country, the individual is deemed to be a resident of the country in which he or she has an habitual abode. If the individual has an habitual abode in both countries or in neither of them, the individual is deemed to be a resident of the country of which he or she is a national (citizen). If the individual is a national of both countries or of neither of them, the competent authorities of the countries are to endeavor to settle the question of residence by mutual agreement.

There is no tie-breaker rule for companies. A company could be treated as a resident of both countries under the basic treaty definition (a dual-resident company) if it is incorporated in the United States but managed and controlled in India. In that case, the company is generally outside the scope of the proposed treaty. Certain provisions of the proposed treaty would apply, however, including the provisions relating to reduced withholding rate on dividends paid, nondiscrimination, mutual agreement procedures, exchange of information and administrative assistance, and entry into force.

This rule is not found in the U.S., OECD, or United Nations model treaties.

In the case of a person other than an individual or a company, e.g., an estate or trust, that is resident of both countries under the basic treaty definition, the proposed treaty requires the competent authorities of the two countries to settle the question by mutual agreement and to determine how the treaty applies to that person. This rule is identical to the corresponding rule in the U.S. model treaty.

Article 5. Permanent Establishment

The proposed treaty contains a definition of the term "permanent establishment" that generally follows the pattern of other recent U.S. income tax treaties and the U.S. and OECD model treaties. However, in order to reflect India's status as a developing country, the proposed treaty definition makes a number of concessions to the principle of taxation of income at source. Some of these concessions reflect positions suggested by the United Nations model income tax treaty for use between developed and developing countries.

The permanent establishment concept is one of the basic devices used in income tax treaties to avoid double taxation. Generally, an enterprise that is a resident of one country is not taxable by the other country on its business profits unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the permanent establishment concept is used to determine whether the reduced rates of, or exemptions from, tax provided for dividends, interest, and royalties apply, or whether those amounts are taxed as business profits. U.S. taxation of business profits is discussed under Article 7.

The principal areas in which the proposed treaty departs from the U.S. model are in its inclusion in the permanent establishment definition of a warehouse (in relation to a person providing storage facilities to others); a farm;[6] a sales outlet; a drilling rig or ship or other installation or structure used for the exploration or development of natural resources in a country for more than 120 days (rather than 12 months); a construction project lasting more than 120 days (rather than 12 months); and an individual performing services (other than certain services to which royalty treatment applies under Article 12) for more than 90 days. Also, the inclusion in the time period of supervisory activity connected with construction activity is a departure from the U.S. model. These departures from the U.S. model, however, are similar to the corresponding provisions of the United Nations model treaty and other recent U.S. income tax treaties with developing countries, such as the treaty with Barbados.

In general, under the proposed treaty, a permanent establishment is a fixed place of business in one country through which the business of an enterprise of the other country is wholly or partly carried on. Under the proposed treaty (as under the U.S. model), a permanent establishment includes a place of management; a branch; an office; a factory; a workshop; a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources; and (as additions not found in the U.S. model) a warehouse (in relation to a person providing storage facilities for others), a farm, and a store or premises used as a sales outlet.

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[6] The treatment of a farm as a permanent establishment is contrary to the U.S. model treaty which provides that income from agricultural operations is taxed as income from immovable (real) property, rather than as business profits. Nevertheless, the result is taxation on a net basis in either case.

Under the proposed treaty, a permanent establishment also includes any installation or structure (including a drilling rig, according to the Treasury's technical explanation of the proposed treaty) used for the exploration or development of natural resources, or any building site, construction, assembly, or installation project, but only if the installation, site, project, etc., lasts for more than 120 days in any twelve-month period (including the period of any connected supervisory activity in the case of building site or construction project, etc.). However, as specified in Ad Article 5 of the proposed protocol, a permanent establishment does not exist in any taxable year in which a site, project, or activity continues for a period or periods aggregating less than 30 days.

An enterprise also has a permanent establishment if it furnishes services, including consultancy, management and technical, or supervisory services in a country through employees or other personnel, but only if these services are performed within that country for more than 90 days in any twelve-month period. No permanent establishment exists, however, in any taxable year in which these services are performed less than 30 days. However, the 90-day minimum requirement does not apply, and a permanent establishment does exist, if the services are performed for an associated enterprise (Article 9). This services provision is similar to the six-month services rule of the United Nations model treaty. It is not found in the U.S. model treaty but has been included, in some form, in some recent U.S. income tax treaties with developing countries (e.g., Barbados, Jamaica, and the Philippines).

The services provision includes an exception for certain technical or consultancy services related to the use of intangibles. A permanent establishment does not result from the provision of such services, on which withholding tax may be imposed at the rate applicable to royalties under Article 12 (Royalties).

The general permanent establishment rule is modified to provide that a fixed place of business that is used for any of a number of specified activities does not constitute a permanent establishment. These activities include the use of facilities solely for storing, displaying, or occasionally delivering merchandise belonging to the enterprise, and the maintenance of a stock of goods belonging to the enterprise solely for purposes of storage, display, or occasional delivery. Also included are the maintenance of goods solely for processing by another person, and the maintenance of a fixed place of business solely for the purchase of goods or merchandise, the collection or provision of information, advertising, scientific research, and similar preparatory or auxiliary activities for the enterprise.

If an enterprise of one country maintains an agent in the other country who has, and habitually exercises, the authority to enter into contracts in that other country in the name of the enterprise, then the enterprise is deemed to have a permanent establishment in the other country with respect to the activities which the agent undertakes on its behalf. This rule does not apply if the contracting authority is limited to those activities (described above) such as storage, display, or delivery of merchandise that are excepted from the definition of permanent establishment. However, the enterprise is treated as having a permanent establishment if the agent habitually maintains in that other country a stock of goods or merchandise from which the agent regularly makes deliveries on behalf of the enterprise and some additional activities conducted in that other country on behalf of the enterprise have contributed to the sale of the goods or merchandise.

In addition, unlike the U.S. model treaty, the enterprise is treated as having a permanent establishment if the agent habitually secures orders in that other country wholly or almost wholly on behalf of that enterprise and the transactions between the agent and the enterprise are not made under arm's-length conditions. As explained in the diplomatic notes exchanged at the time of the signing of the proposed treaty, in order for an agent to be treated as habitually securing orders wholly or almost wholly for the enterprise all of the following tests must be met: (1) The agent frequently accepts orders for goods or merchandise on behalf of the enterprise; (2) substantially all of the agent's sales-related activities in the other country consist of activities for the enterprise; (3) the agent habitually represents to persons offering to buy goods or merchandise that acceptance of an order by the agent constitutes the agreement of the enterprise to supply goods or merchandise under the terms and conditions specified in the order; and (4) the enterprise takes actions that give purchasers the basis for a reasonable belief that the agent has authority to bind the enterprise.

The proposed treaty contains the usual provision that the agency rule does not apply if the agent is a broker, general commission agent, or other agent of independent status acting in the ordinary course of its business. However, the proposed treaty adds the limitation (similar to one found in the United Nations model treaty and some recent U.S. treaties) that, when the activities of the agent are devoted wholly or almost wholly on behalf of that enterprise, the agent is not considered an agent of independent status if the transactions between the agent and the enterprise are not made under arm's-length conditions.

The determination whether a company of one country has a permanent establishment in the other country is to be made without regard to the fact that the company may be related to a company that is a resident of the other country or to a company that engages in business in that other country. Any such relationship is thus not relevant; only the activities of the company being tested are relevant.

Article 6. Income from Real Property

This article covers only income from real property. The rule permitting situs-country taxation of gains from the sale of real property is found in Article 13.

Under the proposed treaty, income derived by a resident of one country from real property situated in the other country, including income from agriculture or forestry, may be taxed in the country where the real property is located. The situs country may tax income derived from the direct use, letting, or use in any other form of real property. This article also applies to the income from real property of an enterprise and to income from real property used for the performance of independent personal services.

The term "real property" has the meaning which it has under the law of the country in which the property in question is situated.

This article is identical to the article of the U.S. model treaty governing income from real property, except that the U.S. model permits a resident of one country to elect to be taxed on a net basis by the other country on income from real property in that other country. Though the proposed treaty does not contain this election, such treatment is provided for U.S. real property income under the Code (secs. 871(d) and 882(d)) and for Indian real property income under Indian domestic law.

Article 7. Business Profits

U.S. Code rules

U.S. law distinguishes between the business income and the investment income of a nonresident alien or foreign corporation. A nonresident alien or foreign corporation is subject to a flat 30-percent rate (or lower treaty rate) of tax on certain U.S. source income if that income is not effectively connected with the conduct of a trade or business within the United States. The regular individual or corporate rates apply to income (from any source) that is effectively connected with the conduct of a trade or business within the United States.

The taxation of income as business or investment income varies depending upon whether the income is U.S. or foreign. In general, U.S. source periodic income (such as interest, dividends, rents, and wages) and U.S. source capital gains are effectively connected with the conduct of a trade or business within the United States only if the asset generating the income is used in or held for use in the conduct of the trade or business, or if the activities of the trade or business were a material factor in the realization of the income. All other U.S. source income of a person engaged in a trade or business in the United States is treated as effectively connected income.

In the case of foreign persons other than insurance companies, foreign source income is effectively connected income only if the foreign person has an office or other fixed place of business in the United States and the income is attributable to that place of business. For such persons, only three types of foreign source income can be effectively connected income: rents and royalties on intangible property derived from the active conduct of a licensing business; dividends or interest derived in the active conduct of a banking, financing, or similar business in the United States (or received by a corporation in the business of trading stocks or securities for its own account); and certain sales income attributable to a U.S. sales office.

The foreign source income of a foreign corporation that is subject to tax under the insurance company provisions of the Code may be treated as U.S.-effectively connected without regard to the foregoing rules, so long as such income is attributable to the U.S. business of the foreign corporation. In addition, the net investment income of such a company which must be treated as effectively connected with the conduct of an insurance business within the United States is not less than an amount based on a combination of asset/liability ratios and rates of return on investments experienced by the foreign person in its worldwide operations and by the U.S. insurance industry.

Trading in stocks, securities, or commodities in the United States for one's own account generally does not constitute a trade or business in the United States, and accordingly, income from those activities is not taxed by the United States as business income. Thus, income from trading through a U.S.-based employee, a resident broker, commission agent, custodian, or other agent, or from trading by a foreign person physically present in the United States is not generally taxed as business income. However, this rule does not apply to a dealer or to a corporation the principal business of which is trading in stocks or securities for its own account.

The Code as amended by the 1986 Act provides that any income or gain of a foreign person for any taxable year which is attributable to a transaction in any other taxable year will be treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other taxable year (Code sec. 864(c)(6)). In addition, the Code provides that if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, the determination of whether any income or gain attributable to a sale or exchange of that property occurring within 10 years after the cessation of business is effectively connected with the conduct of trade or business within the United States shall be made as if the sale or exchange occurred immediately before the cessation of business (Code sec. 864(c)(7)).

Proposed treaty rules

Under the proposed treaty, business profits of an enterprise of one country are taxable in the other country only if the enterprise carries on business through a permanent establishment situated in the other country. This is one of the basic limitations under the treaty on a country's right to tax income of a resident of the other country. The proposed treaty's rules on business profits generally follow the provisions of the U.S. model treaty, except as noted below.

The taxation of business profits under the proposed treaty differs from internal U.S. rules for taxing business profits primarily by requiring more than merely being engaged in a trade or business before a country can tax business profits, and by substituting an "attributable to" standard for the Code's "effectively connected" standard. Under the Code, all that is necessary for effectively connected business profits to be taxed is that a trade or business be carried on in the United States. Under the proposed treaty, on the other hand, some type of fixed place of business generally must be present and the business profits generally must be attributable to that fixed place of business.

For purposes of the proposed treaty, the term "business profits" includes income derived from any trade or business, regardless of whether carried on by an individual, company, partnership, or other person. Income from the furnishing of services and from the rental of tangible personal property is generally included as business profits. However, income from the furnishing of certain technical or consultancy services and income from the rental of certain industrial, commercial, or scientific equipment is not included as business profits, and is instead dealt with only under Article 12, Royalties.

The business profits of a permanent establishment are determined on an arm's-length basis. Thus, there is attributed to a permanent establishment the business profits which might be expected to have been derived by it if it were a distinct and independent entity engaged in the same or similar activities under the same or similar conditions and dealing at arm's-length with the enterprise of which it is a permanent establishment, or with any other associated enterprise. For example, this arm's-length rule applies to transactions between the permanent establishment and a branch of the resident enterprise located in a third country. Amounts may be attributed whether they are from sources within or without the country in which the permanent establishment is located.

Unlike the U.S. model treaty, the proposed treaty provides that if the determination of the correct amount of profits attributable to the permanent establishment is impossible or presents "exceptional difficulties," the amount of profits attributable to the permanent establishment can be estimated on a reasonable basis in accordance with the principles contained in the Article. The Treasury's technical explanation of the proposed treaty expresses the expectation of the United States that this rule would be applied "only in unusual cases."

In computing taxable business profits, deductions generally are allowed under paragraph 3 of Article 7 for expenses, wherever incurred, that are incurred for the purposes of the permanent establishment. These deductions include a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise. However, no deductions are allowed for amounts paid (other than in reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or to any of its other offices, by way of royalties, fees, or other similar payments in return for the use of patents, know-how or other rights, or by way of commissions or other charges for specific services performed or for management, or, except in the case of banking enterprises, by way of interest on money lent to the permanent establishment. Similarly, no account is taken, in the determination of the profits of the permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or to any of its other offices, by way of royalties, fees, or other similar payments in return for the use of patents, know-how or other rights, or by way of commissions or other charges for specific services performed or for management, or, except in the case of banking enterprises, by way of interest on money lent to the head office of the enterprise or to any of its other offices. These rules limiting deductions are not found in the U.S. or OECD model treaties, but are patterned after rules contained in the United Nations model treaty. Similar rules are contained in certain other U.S. income tax treaties with developing countries.

The U.S. model treaty does not permit such head-office deductions to be limited by provisions of local law that may conflict with the principles of the treaty provision. However, the proposed treaty provides for such deductions only in accordance with and subject to the limitations of local tax laws. The tax laws of India limit certain deductions of a permanent establishment for expenses of the head office. Staff is informed that deductions under Indian law for executive and general administrative expenses (not including interest) may not exceed five percent of the adjusted total income of a permanent establishment. Five percent is viewed as an approximate average of head office executive and general administrative expenses incurred by non-Indian companies for the benefit of their Indian permanent establishments. Paragraph II of the proposed protocol (Ad Article 7) recites the understanding of both countries that allowable deductions for such expenses will be no less than the amount allowable under the Indian Income-tax Act as of the date of signature (September 12, 1989). It is not clear that, under the proposed treaty, an Indian permanent establishment of a U.S. company would be able to deduct the full amount of its proper allocation of head office expenses.

Business profits are not attributed to a permanent establishment merely by reason of the purchase of merchandise by the permanent establishment for the account of the enterprise. Thus, if a permanent establishment purchases goods for its head office, the business profits attributed to the permanent establishment with respect to its other activities are not increased by a profit element in its purchasing activities. The amount of profits attributable to a permanent establishment must be determined by the same method each year unless there is good and sufficient reason to change the method.

The proposed treaty includes two rules not in the U.S. model that expand the scope of the business profits that may be attributed to a permanent establishment. Although these two rules do not appear in the U.S. model treaty, similar rules have been included in other recent U.S. income tax treaties. First, paragraph 1 of Article 7 provides that profits derived from sales or other business activities that are similar to the sales or other activities effected through a permanent establishment can be attributed to the permanent establishment. For example, if a U.S. manufacturer of farm equipment has a permanent sales office in India (constituting a permanent establishment under Article 5), and the company effects a sale in India from its home office, then the profits from that sale can be attributed to the permanent establishment and taxed in India. Second, paragraph III of the proposed protocol specifically permits a country to tax business profits attributable to a permanent establishment that no longer exists. That is, a country may tax business profits in a year after a permanent establishment has ceased to exist, if the profits are otherwise attributable to the permanent establishment. For example, income from an installment sale effected through a permanent establishment may be taxed by the country in which the permanent establishment was located, even after the permanent establishment is liquidated.

Where business profits include items of income that are dealt with separately in other articles of the treaty, those other articles, and not this business profits article, govern the treatment of those items of income. Thus, for example, dividends generally are taxed under the provisions of Article 10 and not as business profits, except as provided in paragraph 4 of Article 10.

Article 8. Shipping and Air Transport

As a general rule, the United States taxes the U.S. source income of a foreign person from the operation of ships or aircraft to or from the United States. An exemption from U.S. tax is provided under the Internal Revenue Code for gross income from the operation of ships or aircraft in international traffic derived by foreign persons that are individual residents of or corporations incorporated in foreign countries that grant equivalent exemptions to U.S. individual residents and corporations. The United States has entered into agreements with a number of countries providing reciprocal exemptions.

Under the proposed treaty, profits derived by an enterprise of one country from the operation in international traffic of ships or aircraft ("shipping profits") are exempt from tax by the other country. International traffic means any transportation by ship or aircraft operated by an enterprise of one country, except if the ship or aircraft is operated solely between places within the other country (Article 3(1)(j) (General Definitions)). The exemption applies whether or not the ships or aircraft are registered in the first country. Thus, for example, India would not tax the income of a U.S. resident operating a Liberian-flag vessel.

The exemption for shipping profits applies to profits derived by an enterprise from the transportation by sea or air of passengers, mail, livestock, or goods carried on by the owners, lessees, or charterers of ships or aircraft, including the sale of tickets for such transportation on behalf of other enterprises, other activity directly connected with such transportation, and the rental of ships or aircraft incidental to any activity directly connected with such transportation. Thus, income of an enterprise from the rental of ships or aircraft constitutes exempt shipping profits only if it is incidental to the operation by the enterprise of ships or aircraft in international traffic. For example, under the proposed treaty income from bareboat leasing is exempt only if it is incidental to the operation by the enterprise of ships or aircraft in international traffic. This provision is narrower than the corresponding provision in the U.S. model treaty, which covers not only rental profits that are incidental to transportation activities of the lessor but also any rental profits derived from the operation of ships or aircraft in international traffic by the lessee.

The exemption also applies to income derived from the use, maintenance, or rental of containers (as well as trailers, barges, and related equipment used to transport containers) used in connection with the operation of ships or aircraft in international traffic. Thus, in order to qualify for the exemption, the recipient of the income must be engaged in the operation of ships or aircraft in international traffic and the container or related equipment must be used for the transport of goods in international traffic. The proposed income tax treaty with the Republic of Indonesia contains a similar provision. The comparable provision in the U.S. model treaty (Article 8, paragraph 3) is not limited to situations in which the lessor is engaged in the operation of ships or aircraft in international traffic.

The shipping and air transport provisions also apply to profits from participation in a pool, joint business, or international operating agency. In addition, interest on funds connected with the operation of ships or aircraft in international traffic is treated as profit derived from the operation of ships or aircraft and is not subject to the provisions of Article 11 (Interest). This provision, which would be redundant in a treaty (such as the U.S. model treaty) that exempts interest from all source country taxation, provides an exemption from tax in the source country for interest income derived from the working capital of the enterprise needed for the operation of ships or aircraft in international traffic.

Moreover, gains derived by an enterprise of one country from the alienation of ships, aircraft, and containers are exempt from tax in the other country if the ships, aircraft, and containers are owned and operated by the enterprise and the income from them is taxable only in that country. This provision is narrower than the comparable provision in the U.S. model treaty (paragraph 4 of Article 13 (Gains)) in that the U.S. model treaty covers all gains from the alienation of ships, aircraft, or containers operated in international traffic, regardless of whether they are operated by the owner or by a lessee.

Article 9. Associated Enterprises

The proposed treaty, like most other U.S. tax treaties, contains an arm's-length pricing provision similar to Code section 482 that recognizes the right of each country to make an allocation of income to that country in the case of transactions between related enterprises, if an allocation is necessary to reflect the conditions and arrangements that would have been made between independent enterprises.

For purposes of the proposed treaty, an enterprise of one country is related to an enterprise of the other country if one of the enterprises participates directly or indirectly in the management, control, or capital of the other enterprise. The enterprises are also related if the same persons participate directly or indirectly in the management, control, or capital of both enterprises.

When a redetermination of tax liability has been properly made by one country, the other country must make an appropriate adjustment to the amount of tax paid in that country on the redetermined income. In making that adjustment, due regard is to be paid to other provisions of the treaty and the competent authorities of the two countries are to consult with each other if necessary.

The proposed treaty does not include a paragraph in the Associated Enterprises article of the U.S. model treaty which states explicitly that the article is not intended to limit any law in either country which permits the distribution, apportionment, or allocation of income, deductions, credits, or allowances between non-independent persons when such allocation is necessary to prevent evasion of taxes or to reflect clearly the income of those persons. However, it is understood that Article 9 does not in fact limit the application of U.S. internal law (including the "commensurate with income" standard for pricing transfers and licenses of intangible property) in this regard. Thus, under the proposed treaty, the United States retains the right to apply its inter-company pricing rules (sec. 482) and its rules relating to the allocation of deductions (Code secs. 861, 862, and 863, and applicable regulations).

Article 10. Dividends

The United States imposes a 30-percent withholding tax on the gross amount of U.S. source dividends (other than dividends paid by an "80/20 company" described in Code section 861(c)) paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In such a case, the foreign recipient is subject to U.S. tax like a U.S. person at the standard graduated rates, on a net basis. U.S. source dividends, for this purpose, are dividends paid by a U.S. corporation.[7]

Similarly, India imposes a withholding tax at the rate of 25 percent on dividend payments to nonresident shareholders.

The proposed treaty generally follows the provisions of the U.S. model treaty, with certain exceptions. Under the proposed treaty, each country may tax dividends paid by its resident companies, but the tax is generally limited to 25 percent of the gross amount of the dividend if the beneficial owner of the dividend is a resident of the other country. The tax is limited to 15 percent of the gross amount of the dividend if the beneficial owner is a company that owns at least 10 percent of the voting stock of the company paying the dividend. This rule does not restrict the right of a country to tax the profits out of which dividends are paid. These rates are higher than the 15-percent and 5-percent rates provided for in the U.S. model treaty and most U.S. tax treaties. In addition, staff is informed that a proposed tax treaty between India and Japan, which was signed in 1989, provides a maximum source country tax rate of 15 percent on all dividends, regardless of stock ownership.[8]

Under the proposed treaty, the 15-percent rate for dividends paid to 10-percent corporate shareholders does not apply to dividends paid by a U.S. regulated investment company (RIC). All dividends paid by a RIC are subject to the treaty's 25-percent rate regardless of the recipient's ownership of the RIC. The reduced rate for 10-percent shareholders, like the domestic dividends-received deduction, is generally justified as relief from multiple levels of corporate taxation in cases where the dividend recipient holds a significant ownership interest in the payor corporation. In the case of an investment through a RIC, however, a person is not likely to hold a 10-percent interest (on a look-through basis) in the taxable corporation that pays the dividend which is passed through the RIC, regardless of the person's ownership of the RIC.

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[7] Also treated as U.S. source dividends for this purpose is an allocated portion of certain dividends paid by a foreign corporation that is exempt from the application of the branch profits tax by the operation of a U.S. tax treaty, if at least 25 percent of the gross income of the foreign corporation, in the prior three-year period, was effectively connected with a U.S. trade or business of that foreign corporation. The tax imposed on the latter dividends is often referred to as the "second-tier" withholding tax.

[8] Staff is further informed that tax-sparing credits are to be provided by Japan under the proposed tax treaty between India and Japan.

Similarly, the 15-percent rate for dividends paid to 10-percent shareholders does not apply to dividends paid by a U.S. real estate investment trust (REIT). In addition, dividends paid by a REIT are eligible for the treaty's 25-percent rate (rather than the statutory 30-percent rate) only if the beneficial recipient of the dividend is an individual resident of India who owns *less* than 10 percent of the REIT.

Like the U.S. model treaty, the proposed treaty defines "dividends" as income from shares or other rights which participate in profits and which are not debt claims. Dividends also include (1) income from other corporate rights that is subjected to the same tax treatment by the country in which the distributing corporation is resident as income from shares, as well as (2) income from arrangements (including debt obligations) that carry the right to participate in profits, to the extent so characterized under the laws of the country in which the income arises. Under this provision, each country may apply its own rules for determining whether a payment by a resident company is treated as a devidend.

The treaty limitation on source country dividend tax does not apply if the beneficial owner of the dividend has a permanent establishment (or fixed base in the case of an individual performing independent personal services) in the source country and the dividend is attributable to that permanent establishment (or fixed base). Dividends attributable to a permanent establishment or fixed base are to be taxed as business profits (Article 7), even if the dividend payments are deferred until the permanent establishment or fixed base has ceased to exist (paragraph III of the proposed protocol). Dividends attributable to an individual's fixed base are to be taxed as income from independent personal services (Article 15).

Under the proposed treaty, one country may tax dividends paid by a company resident in the other country in only two cases. First, a country may always tax dividends that are paid to a resident of that country. Second, a country may tax dividends insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or fixed base located in that country. For example, if a permanent establishment located in India held the stock of a U.S. company, then India could tax a dividend paid by the U.S. company with respect to that stock, even if the dividend were actually paid to the owner of the permanent establishment in a country other than India. However, consistent with Article 14 (Permanent Establishment Tax) permitting imposition of a branch profits tax on foreign corporations, and consistent with the Code's elimination of second-tier withholding tax in such a case, the proposed treaty does not otherwise permit the imposition of withholding tax by one country on a dividend paid by a company resident in the other country, even if the profits out of which the dividend is paid are attributable to a permanent establishment in the first-mentioned country.

The proposed treaty exempts a company resident in one country that derives profits or income in the other country from tax on undistributed profits in that other country. However, the U.S. accumulated earnings tax is not affected by the proposed treaty pursuant to paragraph 1(a) of Article 2 (Taxes Covered), and the U.S. branch profits tax is specifically permitted under Article 14 (Permanent Establishment Tax). Staff is informed that no tax currently imposed by either the United States or India is subject to this restriction.

Under the saving clause of Article 1(3) (General Scope), the United States may always tax its citizens on their dividend income, even if the dividend article of the proposed treaty would otherwise apply. For example, a U.S. citizen resident in India who receives a dividend from an Indian corporation can be taxed by the United States, even though Article 10 otherwise prohibits a U.S. tax in that case.

Article 11. Interest

Subject to numerous exceptions (such as those for portfolio interest, bank deposit interest, and short-term original issue discount), the United States imposes a 30-percent tax on U.S. source interest paid to foreign persons under the same rules that apply to dividends. U.S. source interest, for this purpose, generally is interest on debt obligations of U.S. persons, other than a U.S. person that meets the foreign business requirements of Code section 861(c) (e.g., an 80/20 company). Also subject to the 30-percent tax is interest paid by the U.S. trade or business of a foreign corporation.

Under the proposed treaty, interest may be taxed by a country if the beneficial owner of the interest is a resident of that country or if the interest arose in that country. The proposed treaty limits the withholding tax imposed at source on interest paid to a beneficial owner who is a resident of the other country to 10 percent in the case of a loan granted by a bank carrying on a bona fide banking business or by a similar financial institution (including an insurance company), and 15 percent otherwise. The U.S. model treaty provides for elimination of the withholding tax on portfolio interest (a zero rate), although this result is often not achieved.

The lower rate in the proposed treaty applies only if the interest is beneficially owned by a resident of the other country. Accordingly, it does not apply if the recipient is a nominee for a nonresident.

The reduced tax rate does not apply if the recipient carries on business through a permanent establishment or fixed base in the source country and the interest is attributable to that permanent establishment or fixed base. In that event, the interest is taxed as business profits (Article 7) or income from the performance of independent personal services (Article 15), even if the interest payments are deferred until the permanent establishment or fixed base has ceased to exist (under paragraph III of the proposed protocol).

The proposed treaty defines interest to mean income from debt claims of every kind, ~~whether~~ or not secured by mortgage, and whether or not carrying a right to participate in profits. Interest includes income from Government securities, bonds, or debentures, including premiums and prizes attaching to such securities, bonds or debentures, but not including any penalties for late payment. The definition of interest specifically excludes any income (including income from debt-claims) that is dealt with under Article 10 (Dividends).

Interest is exempt from source country tax under the proposed treaty if the interest is (a) derived and beneficially owned by the other country or any political subdivision or local authority of that other country, the Reserve Bank of India, or the Federal Reserve Banks of the United States, as the case may be, or such other institutions of either country as the competent authorities may agree (pursuant to Article 27); (b) paid with respect to loans or credits extended or endorsed by the Export-Import Bank of the United States or the EXIM Bank of India; or (c) derived and beneficially owned by any person (other than a governmental or quasi-governmental person described in (a) or (b)) who is a resident of the other country, provided that and to the extent that the transaction giving rise to the debt claim is approved by the Government of that country. Staff is informed that Indian statutory law provides an exemption for interest on such debt claims that are approved for exemption by the Government of India.

The proposed treaty provides a source rule for interest (which is also used in Article 25 (Relief from Double Taxation) for foreign tax credit purposes). Interest is sourced within a country if the payor is the government of that country, including political subdivisions and local authorities, or a resident of that country. However, if the interest is borne by a permanent establishment (or fixed base) that the payor has in India or the United States and the indebtedness is incurred with respect to that permanent establishment (or fixed base), interest has its source in that country, regardless of the residence of the payor. Generally, this is consistent with U.S. source rules (Code secs. 861-862), which provide that interest income is sourced in the country in which the payor is resident, and with the effect of the branch-level interest rules (Code sec. 884(f)(1)(A)), which subject interest paid to a foreign person by the U.S. branch of a foreign corporation to the U.S. withholding tax rules. Thus, for example, if a Swiss resident with a permanent establishment in India incurs indebtedness to a U.S. person for that Indian permanent establishment, and the permanent establishment bears the interest, then the interest has its source in India.

The proposed treaty addresses the issue of non-arm's-length interest charges between parties having a direct or indirect special relationship by providing that the amount of interest for purposes of the treaty is the amount of arm's-length interest. The amount of interest in excess of the arm's-length interest is taxable according to the laws of each country, taking into account the other provisions of the treaty (e.g., excess interest paid to a shareholder may be treated as a dividend under local law and thus entitled to the benefits of Article 10 of the treaty).

As in the case of dividends, under the saving clause of Article 1(3) (General Scope) the United States may always tax its citizens on their interest income, even if they are resident in India.

Article 12. Royalties and Fees for Included Services

Description

Under the same system that applies to dividends and interest, the United States imposes a 30-percent tax on U.S. source royalties paid to foreign persons. Royalties are from a U.S. source if they are for the use of property located in the United States. U.S. source royalties include royalties for the use of or the right to use intangibles in the United States, including motion picture royalties.

The U.S. model treaty exempts royalties from tax at source. The proposed treaty, however, allows limited source-basis taxation of royalties. Royalties from sources in one country (determined under the royalty source rule discussed below) that are beneficially owned by a resident of the other country may be taxed by both countries. The maximum rate of source-basis taxation is generally 15 percent or 10 percent, depending on the type of property with respect to which the royalty is paid. In some cases a temporary 20-percent rate may apply. If a payment is received as a royalty of the first type defined below, it may be taxed in the source country at a rate that generally may not exceed 15 percent. However, during the first five years that the treaty is in effect, the 15-percent rate only applies to royalties paid by the Government, a political subdivision, or a public sector company of the source country; all other royalties of the first type may be taxed by the source country at the rate of 20 percent during that five-year period. If a payment is received as a royalty of the second type defined below, it may be taxed by the source country at a rate that may not exceed 10 percent.

The proposed treaty defines two types of "royalties" in paragraph 3 of Article 12. First, "royalties" are defined as payments of any kind received as a consideration for the use of, or the right to use, any copyright of a literary, artistic, or scientific work, including cinematographic films or work on film, tape or other means of reproduction for use in connection with radio or television broadcasting; any patent, trademark, design or model, plan, secret formula or process; or for information concerning industrial, commercial or scientific equipment, including gains derived from the alienation of any such right or property which are contingent on the productivity, use or disposition of such right or property. As discussed in Treasury's technical explanation of the proposed treaty, the term "information concerning industrial, commercial, or scientific experience" alludes to the concept of know-how and means information that is not publicly available and that cannot be known from mere examination of a product and mere knowledge of the progress of technique. As provided in the Commentaries on the Articles of the OECD Model Convention (paragraph 12 of the Art. 12 Comm.): "In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public." Second, "royalties" are defined also to include payments of any kind received as a consideration for the use of, or the right to use, any industrial, commercial or scientific equipment (other than such payments as are exempt from source country taxation under the provisions of Article 8 (Shipping and Air Transport).

The treaty's royalty definition roughly follows that of the OECD and United Nations model treaties. The royalty definition in the proposed treaty differs from the corresponding definition in the U.S. model treaty in that royalties under the proposed treaty (1) include payments for property rights related to cinematographic films or work on film, tape or other means of reproduction for use in connection with radio or television broadcasting, but (2) do not include payments in respect of "other like right or property." Definitions similar to those in the proposed treaty have been included in other recent U.S. income tax treaties, such as those with Australia, Jamaica, and Barbados.

Unlike the U.S. model treaty, the proposed treaty treats certain "fees for included services" in the same manner as royalties. The proposed treaty (in paragraph 4 of Article 12) defines fees for included services generally to mean payments of any kind to any person in consideration for the rendering of any technical or consultancy services (including through the provision of services of technical or other personnel) if such services either (a) are ancillary and subsidiary to the application or enjoyment of the right, property or information for which a royalty payment is received; or (b) make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design. However, paragraph 5 of Article 12 lists specific exclusions from the definition of fees for included services, for any amounts paid:

(a) for services that are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of property other than a contingent sale where the gain is treated as a royalty under the treaty;

(b) for services that are ancillary and subsidiary to the rental of ships, aircraft, containers or other equipment used in connection with the operation of ships or aircraft in international traffic;

(c) for teaching in or by educational institutions;

(d) for services for the personal use of the individual or individuals making the payment; or

(e) to an employee of the person making the payments or to any individual or firm of individuals (other than a company) for professional services as defined in Article 15 (Independent Personal Services). Thus, a payment to an individual or firm of individuals, such as a partnership, for professional services is subject to tax only under Article 15 and is not subject to tax under Article 12.

Fees for included services that are ancillary and subsidiary to the enjoyment of property for which a royalty of the second type is received are subject to the same 10-percent maximum tax rate as royalties of the second type. All other fees for included services are subject to the same 15- or 20-percent maximum tax rate as royalties of the first type.

The rate limitations in the proposed treaty apply only if the royalty or fee is beneficially owned by a resident of the other country; they do not apply if the recipient is a nominee for a nonresident. They also do not apply if the recipient is an enterprise carrying on business through a permanent establishment in the source country or an individual performing personal services in an independent capacity through a fixed base in the source country, and the royalty or fee is attributable to the permanent establishment or fixed base (even if the royalty or fee is deferred until the permanent establishment or fixed base has ceased to exist (under Paragraph III of the proposed protocol)). In that event, the royalties or fees are taxed as business profits (Article 7) or as income from the performance of independent personal services (Article 15).

The treatment of service fees provided in the proposed treaty is a departure from the domestic law of both the United States and India. Staff is informed that, under Indian statutory law, a broad range of service fees (fees for technical, managerial, or consultancy services performed anywhere) is subject to a 30-percent gross basis tax. Under U.S. statutory law, fees for services performed inside the United States are subject to tax on a net basis if effectively connected with a U.S. trade or business of a nonresident alien or foreign corporation, or on a gross basis (at the rate of 30 percent) only if not effectively connected. Paragraph IV of the proposed protocol (Ad Article 12) clarifies that, if fees for included services may be taxed by the United States under Article 12 but are subject to net basis taxation under internal U.S. law, the level of that net basis taxation (or, where applicable, the sum of that net basis tax and the amount of the tax allowable under paragraph 1 of Article 14 (Permanent Establishment Tax) with respect to those fees) is not to exceed the gross basis tax at the limited rates imposed under Article 12. The term "fees for included services" is not defined (apart from the proposed treaty) in the domestic laws of either country.

As explained in the Diplomatic Note Relating to the Memorandum of Understanding on Article 12, a memorandum of understanding was developed by the negotiators indicating how the provisions of the Article relating to the scope of "included services" are to be understood both by the competent authorities and by taxpayers in the two countries. As further explained in the Diplomatic Note, this memorandum of understanding represents the views of the Governments of both countries when the proposed treaty was signed. Both Governments anticipated that, as the competent authorities and taxpayers gain more experience with the concept of fees for included services, further guidance would be developed and made public.

The memorandum of understanding describes in some detail the category of services included in the proposed treaty's definition of fees for included services (Article 12). It also provides examples of services intended to be covered within the definition of included services and those intended to be excluded, either because they do not satisfy the general definition or because they are specifically excluded by Article 12. The examples in either case are not intended as an exhaustive list but rather as illustrating a few typical cases. For ease of understanding, the examples in the memorandum describe U.S. persons providing services to Indian persons, but the rules of Article 12 are reciprocal in application.

The memorandum of understanding first defines the terms "technical services" and "consultancy services," which are the only types of services that are considered "included services" under the general definition (paragraph 4 of Article 12). A technical service means a service requiring expertise in a technology. A consultancy service means an advisory service. These two categories are to some extent overlapping because a consultancy service could also be a technical service. However, the category of consultancy services also includes an advisory service, whether or not expertise in a technology is required to perform it.

Under the general definition, technical and consultancy services are considered included services only to the extent that: (1) they are ancillary and subsidiary to the application or enjoyment of a right, property or information for which a royalty payment is made; or (2) they make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design. Thus, consultancy services that are not of a technical nature cannot be included services.

The general definition refers to technical or consultancy services that are ancillary and subsidiary to the application or enjoyment of any right, property, or information for which a royalty payment is received. Thus, the definition includes technical and consultancy services that are either ancillary and subsidiary to the application or enjoyment of an intangible for which a royalty of the first type is received under a license or sale, or ancillary and subsidiary to the application or enjoyment of industrial, commercial, or scientific equipment for which a royalty of the second type is received under a lease.

It is understood that, in order for a service fee to be considered "ancillary and subsidiary" to the application or enjoyment of some right, property, or information for which a royalty is received, the service must be related to the application or enjoyment of the right, property, or information. In addition, the clearly predominant purpose of the arrangement under which the payment of the service fee and such other payment are made must be the application or enjoyment of the right, property, or information. The question of whether the service is related to the application or enjoyment of the right, property, or information and whether the clearly predominant purpose of the arrangement is such application or enjoyment must be determined by reference to the facts and circumstances of each case. Factors which may be relevant to such determination (although not necessarily controlling) include:

(1) The extent to which the services in question facilitate the effective application or enjoyment of the right, property, or information described in paragraph 3 of Article 12;

(2) the extent to which such services are customarily provided in the ordinary course of business arrangements involving royalties described in paragraph 3;

(3) whether the amount paid for the services (or which would be paid by parties operating at arm's length) is an insubstantial portion of the combined payments for the services and the right, property, or information described in paragraph 3;

(4) whether the payment made for the services and the royalty described in paragraph 3 are made under a single contract (or a set of related contracts); and

(5) whether the person performing the services is the same person as, or a related person to, the person receiving the royalties described in paragraph 3. For this purpose, persons are considered related if their relationship is described in Article 9 (Associated En-

terprises) or if the person providing the service is doing so in connection with an overall arrangement which includes the payor and recipient of the royalties.

To the extent that services are not considered ancillary and subsidiary to the application or enjoyment of some right, property, or information for which a royalty payment is made, (as described in paragraph 4(a), part (a) of the general definition) such services are considered "included services" only to the extent that they make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design (as described in paragraph 4(b), part (b) of the general definition).

The memorandum of understanding presented two examples of the application of paragraph 4(a). The first example illustrates services that are "included services".

Examples

Example (1)

Facts:

A U.S. manufacturer grants rights to an Indian company to use manufacturing processes in which the transferor has exclusive rights by virtue of process patents or the protection otherwise extended by law to the owner of a process. As part of the contractual arrangement, the U.S. manufacturer agrees to provide certain consultancy services to the Indian company in order to improve the effectiveness of the latter's use of the processes. Such services include, for example, the provision of information and advice on sources of supply for materials needed in the manufacturing process, and on the development of sales and service literature for the manufactured product. The payments allocable to such services do not form a substantial part of the total consideration payable under the contractual arrangement. Are the payments for these services fees for "included services"?

Analysis:

The payments are fees for included services. The services described in this example are ancillary and subsidiary to the use of a manufacturing process protected by law as described in paragraph 3(a) of Article 12 because the services are related to the application or enjoyment of the intangible and the granting of the right to use the intangible is the clearly predominant purpose of the arrangement.

Because the services are ancillary and subsidiary to the use of the manufacturing process, the fees for these services are considered fees for included services under paragraph 4(a) of Article 12, regardless of whether the services are described in paragraph 4(b).

Example 1 illustrates the application of paragraph 4(a) using services that are not also described in paragraph 4(b). These services are not described in section 4(b) because they do not make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design. The services described in Example 1 are limited to the provision of procurement and marketing information.

The second example illustrates services which are not "included services".

Example 2

Facts:

An Indian manufacturing company produces a product that must be manufactured under sterile conditions using machinery that must be kept completely free of bacterial or other harmful deposits. A U.S. company has developed a special cleaning process for removing such deposits from that type of machinery. The U.S. company enters into a contract with the Indian company under which the former will clean the latter's machinery on a regular basis. As part of the arrangement, the U.S. company leases to the Indian company a piece of equipment which allows the Indian company to measure the level of bacterial deposits on its machinery in order for it to know when cleaning is required. Are the payments for the services fees for included services?

Analysis:

In this example, the provision of cleaning services by the U.S. company and the rental of the monitoring equipment are related to each other. However, the clearly predominant purpose of the arrangement is the provision of cleaning services. Thus, although the cleaning services might be considered technical services, they are not "ancillary and subsidiary" to the rental of the monitoring equipment. Accordingly, the cleaning services are not "included services" within the meaning of paragraph 4(a).

Example 2 illustrates the treatment of a service that could be considered technical in nature but that is not described in paragraph 4(b) because it does not make available (as described below) to the purchaser technical knowledge or a technical plan, design or process. Because the service described in Example 2 is not "included services" within the meaning of example 4(a) or (b), it is not subject to tax under Article 12. The service, therefore, is taxable in India only to the extent provided under Article 7 (Business Profits) or Article 15 (Independent Personal Services).

Paragraph 4(b) of Article 12 refers to technical or consultancy services that make available to the person acquiring the service technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design to such person. The memorandum of understanding explains that, for this purpose, the person acquiring the service is deemed to include an agent, nominee, or transferee of such person. The category described in paragraph 4(b) is narrower than the category described in paragraph 4(a) because it excludes any service that does not make technology available to the person acquiring the service.

The memorandum of understanding states that generally technology is considered "made available" when the person acquiring the service is enabled to apply the technology. The fact that the provision of the service may require technical input by the person providing the service does not mean per se that technical knowledge, skills, etc. are made available to the person purchasing the service, within the meaning of paragraph 4(b). Similarly, the use of a product which embodies technology is not considered per se to make the technology available.

As described in the memorandum of understanding, typical categories of services that generally involve either the development and transfer of technical plans or technical designs, or making technology available as described in paragraph 4(b) include:

(1) engineering services (including the subcategories of bioengineering and aeronautical, agricultural, ceramics, chemical, civil, electrical, mechanical, metallurgical, and industrial engineering);

(2) architectural services; and

(3) computer software development.

As explained in the memorandum of understanding, technical and consultancy services could make technology available in a variety of settings, activities and industries. Such services may, for example, relate to any of the following areas:

(1) bio-technical services;

(2) food processing;

(3) environmental and ecological services;

(4) communication through satellite or otherwise;

(5) energy conservation;

(6) exploration or exploitation of mineral oil or natural gas;

(7) geological surveys;

(8) scientific services; and

(9) technical training.

The memorandum of understanding provides examples (Examples 3-12) in order to indicate the scope of the conditions in paragraph 4(b):

Example (3)

Facts:

A U.S. manufacturer has experience in the use of a process for manufacturing wallboard for interior walls of houses which is more durable than the standard products of its type. An Indian builder wishes to produce this product for its own use. It rents a plant and contracts with the U.S. company to send experts to India to show engineers in the Indian company how to produce the extra-strong wallboard. The U.S. contractors work with the technicians in the Indian firm for a few months. Are the payments to the U.S. firm considered to be payments for "included services"?

Analysis:

The payments would be fees for included services. The services are of a technical or consultancy nature; in the example they have elements of both types of services. The services make available to the Indian company technical knowledge, skill and processes.

Example (4)

Facts:

A U.S. manufacturer operates a wallboard fabrication plant outside India. An Indian builder hires the U.S. company to produce wallboard at that plant for a fee. The Indian company provides the raw materials, and the U.S. manufacturer fabricates the wallboard in its plan, using advanced technology. Are the fees in this example payments for included services?

Analysis:

The fees would not be for included services. Although the U.S. company is clearly performing a technical service, no technical knowledge, skills, etc., are made available to the Indian company, nor is there any development and transfer of a technical plan or design. The U.S. company is merely performing a contract manufacturing service.

Example (5)

Facts:

An Indian firm owns inventory control software for use in its chain of retail outlets throughout India. It expands its sales operation by employing a team of travelling salesmen to travel around the countryside selling the company's wares. The company wants to modify its software to permit the salesmen to access the company's central computers for information on what products are available in inventory and when they can be delivered. The Indian firm hires a U.S. computer programming firm to modify its software for this purpose. Are the fees which the Indian firm pays treated as fees for included services?

Analysis:

The fees are for included services. The U.S. company clearly performs a technical service for the Indian company, and it transfers to the Indian company the technical plan (i.e., the computer program) which it has developed.

Example (6)

Facts:

An Indian vegetable oil manufacturing company wants to produce a cholesterol-free oil from a plant which produces oil normally containing cholesterol. An American company has developed a process for refining the cholesterol out of the oil. The Indian company contracts with the U.S. company to modify the formulas which it uses so as to eliminate the cholesterol, and to train the employees of the Indian company in applying the new formulas. Are the fees paid by the Indian company for included services?

Analysis:

The fees are for included services. The services are technical, and the technical knowledge is made available to the Indian company.

Example (7)

Facts:

The Indian vegetable oil manufacturing firm has mastered the science of producing cholesterol-free oil and wishes to market the product world-wide. It hires an American marketing consulting firm to do a computer simulation of the world market for such oil and to advise it on marketing strategies. Are the fees paid to the U.S. company for included services?

Analysis:

The fees would not be for included services. The American company is providing a consultancy service which involves the use of substantial technical skill and expertise. It is not, however, making available to the Indian company any technical experience, knowledge or skill, etc., nor is it transferring a technical plan or design. What is transferred to the Indian company through the service contract is commercial information. The fact that technical skills were required by the performer, or the service in order to perform the commercial information services does not make the service a technical service within the meaning of 4(b).

Examples 3, 5, and 6 illustrate services that would be described in paragraph 4(b). Example 3 refers to services that could be considered typical of the type of service that is described in that paragraph because the Indian builder is paying to have a technical process made available to it. Examples 5 and 6 illustrate other services, each of which is technical in nature under circumstances in which a technical process is made available to the purchaser.

Examples 4 and 7, however, do not illustrate a service that is described in paragraph 4(b) because, although performing each service requires technical knowledge and skill, no technical knowledge, plan, design or process is made available to the purchaser. In Example 4, the technical knowledge used in making wallboard is retained by the U.S. company acting as a contract manufacturer in the transaction. The Indian purchaser is paying for the manufacture of a product by the U.S. company—a type of commercial service. Similarly, in Example 7, the technical knowledge required to complete a computer survey of the world market for a product is retained by the marketing consultant. The Indian purchaser is paying for a commercial service.

The specific exclusions to the general definition of fees for included services (subparagraphs (a) through (e), paragraph 5 of Article 12) describes several categories of services which are not intended to be treated as included services even if they otherwise satisfy the tests of paragraph 4. The memorandum of understanding provides examples of cases where fees would be included under paragraph 4, but are excluded because of the application of one of the conditions of paragraph 5.

Example (8)

Facts:

An Indian company purchases a computer from a U.S. computer manufacturer. As part of the purchase agreement, the manufacturer agrees to assist the Indian company in setting up the computer and installing the operating system, and to ensure that the staff of the Indian company is able to operate the computer. Also as part of the purchase agreement, the seller agrees to provide, for a period of ten years, any updates to the operating system and any training necessary to apply the update. Both of these service elements to the contract would qualify under paragraph 4(b) as an included service. Would either or both be excluded from the category of included services, under paragraph 5(a), because they are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of the computer?

Analysis:

The installation assistance and initial training are ancillary and subsidiary to the sale of the computer, and they are also inextricably and essentially linked to the sale. The computer would be of little value to the Indian purchaser without these services, which are most readily and usefully provided by the seller. The fees for installation assistance and initial training, therefore, are not fees for included services, since these services are not the predominant purpose of the arrangement.

The services of updating the operating system and providing associated necessary training may well be ancillary and subsidiary to the sale of the computer, but they are not inextricably and essentially linked to the sale. Without the upgrades, the computer will continue to operate as it did when purchased, and will continue to accomplish the same functions. Acquiring the updates cannot, therefore, be said to be inextricably and essentially linked to the sale of the computer.

Example (9)

Facts:

An Indian hospital purchases an X-ray machine from a U.S. manufacturer. As part of the purchase agreement, the manufacturer agrees to install the machine, to perform an initial inspection of the machine in India, to train hospital staff in the use of the machine, and to service the machine periodically during the usual warranty period (2 years). Under an optional service contract purchased by the hospital, the manufacturer also agrees to perform certain other services throughout the life of the machine, including periodic inspections and repair services, advising the hospital about developments in X-ray film or techniques which could improve the effectiveness of the machine, and training hospital staff in the application of those new developments. The cost of the initial installation, inspection, training, and warranty service is relatively minor as compared with the cost of the x-ray machine. Is any of the service described here ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of the x-ray machine?

Analysis:

The initial installation, inspection, and training services in India and the periodic service during the warranty period are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of the x-ray machine because the usefulness of the machine to the hospital depends on this service, the manufacturer has full responsibility during this period, and the cost of the services is a relatively minor component of the contract. Therefore, under paragraph 5(a) these fees are not fees for included services, regardless of whether they otherwise would fall within paragraph 4(b).

Neither the post-warranty period inspection and repair services, nor the advisory and training services relating to new developments are "inextricably and essentially linked" to the initial purchase of the x-ray machine. Accordingly, fees for these services may be treated as fees for included services if they meet the test of paragraph 4(b).

Example (10)

Facts:

An Indian automobile manufacturer decides to expand into the manufacture of helicopters. It sends a group of engineers from its design staff to a course of study conducted by MIT for two years to study aeronautical engineering. The Indian firm pays tuition fees to MIT on behalf of the firm's employees. Is the tuition fee a fee for an included service within the meaning of Article 12?

Analysis:

The tuition fee is clearly intended to acquire a technical service for the firm. However, the fee paid is for teaching by an educational institution, and is, therefore, under paragraph 5(c), not an included service. It is irrelevant for this purpose whether MIT conducts the course on its campus or at some other location.

Example (11)

Facts:

As in Example (10), the automobile manufacturer wishes to expand into the manufacture of helicopters. It approaches an Indian university about establishing a course of study in aeronautical engineering. The university contracts with a U.S. helicopter manufacturer to send an engineer to be a visiting professor of aeronautical engineering on its faculty for a year. Are the amounts paid by the university for these teaching services fees for included services?

Analysis:

The fees are for teaching in an educational institution. As such, pursuant to paragraph 5(c), they are not fees for included services.

Example (12)

Facts:

An Indian wishes to install a computerized system in his home to control lighting, heating and air conditioning, a stereo sound system and a burglar and fire alarm system. He hires an American electrical engineering firm to design the necessary wiring system, adapt standard software, and provide instructions for installation.

Are the fees paid to the American firm by the Indian individual fees for included services?

Analysis:

The services in respect of which the fees are paid are of the type which would generally be treated as fees for included services under paragraph 4(b). However, because the services are for the personal use of the individual making the payment, under paragraph 5(d) the payments would not be fees for included services.

The proposed treaty provides a special source rule for royalties and fees. Generally, as indicated above, under U.S. tax rules (Code secs. 861-62), royalty income is sourced where the property or right is being used. Under the proposed treaty, if a royalty or fee is paid by the Government of one of the countries, including political subdivisions and local authorities, or by a resident of one of the countries, then the royalty or fee generally is sourced in the country of residence of the payor. However, if the payor has a permanent establishment or fixed base in one of the countries in connection with which the obligation to pay the royalty or fee was incurred, and if the royalty or fee is borne by the permanent establishment or fixed base, then the royalty or fee arises in the country in which the permanent establishment or fixed base is situated, regardless of the residence of the payor. This provision is also found in the United Nations model treaty.

In the case of any royalty or fee not covered by the just-described source rule, a royalty is sourced in the country in which the property or right is used, and a fee is sourced in the country in which the services are performed. Thus, the proposed treaty's source rules override the United States' statutory "place of use" source rule in the case of any conflict. For example, if a U.S. resident licenses a patent to a resident of India (or in connection with a permanent establishment located in India which bears the royalty payment), the treaty provides that the royalty is sourced in (and taxable by) India. Even if the patent is used within the United States, notwithstanding the statutory source rules of the United States, the royalty is sourced in India under the proposed treaty.

The proposed treaty addresses the issue of non-arm's-length royalties or fees between related parties (or parties having an otherwise special relationship) by providing that the amount of royalties or fees for purposes of applying this article is the amount of arm's-length royalties or fees. Any amount of royalties or fees paid in excess of the arm's-length royalty or fee is taxable according to the laws of each country, taking into account the other provisions of the proposed treaty. For example, excess royalties paid to a parent corporation may be treated as dividends under local law and thus be treated under Article 10 of the proposed treaty.

As in the case of dividends and interest, under the saving clause of Article 1(3) (General Scope) the United States may always tax its citizens on their royalty or fee income, even if they are resident in India.

Article 13. Gains

Generally under U.S. law, gain realized by a nonresident alien or a foreign corporation from the sale of a capital asset is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business or, in the case of a nonresident alien, the individual is physically present in the United States for at least 183 days in the taxable year. However, under the Foreign Investment in Real Property Tax Act of 1980, as amended ("FIRPTA"), a nonresident alien or foreign corporation is taxed by the United States on gain from the sale of a U.S. real property interest as if the gain were effectively connected with a trade or business conducted in the United States. "U.S. real property interests" include interests in certain corporations holding U.S. real property.

Under the proposed treaty, capital gains generally are subject to the domestic tax laws of each country. The single exception provided in the proposed treaty is the taxation of certain gains derived by an enterprise of one country from the disposition of ships, aircraft, or containers operated in international traffic that are exempted from source country taxation by Article 8 (Shipping and Air Transport).

The treatment of capital gains under the proposed treaty differs substantially from the corresponding treatment provided in treaties that follow the U.S. model tax treaty. Under the U.S. model treaty, the only capital gains that may be taxed by the source country are gains from the disposition of real property (generally defined to include all FIRPTA gains), gains from the disposition of personal property which are attributable to a permanent establishment that an enterprise of one country has in the other country, gains from the alienation of personal property attributable to a fixed base available to a resident of one country in the other country for the purpose of performing independent personal services, and gains from the disposition of such a permanent establishment (alone or together with the whole enterprise) or of such a fixed base. Under the U.S. model treaty, gains derived from the disposition of any other property is taxable only in the seller's country of residence.

Article 14. Permanent Establishment Tax

For taxable years beginning after December 31, 1986, as provided in the 1986 Act, a U.S. branch of a non-U.S. corporation is subject to a branch profits tax in the United States on any deemed repatriation of the branch's U.S. effectively connected earnings and profits. The branch profits tax is imposed at the statutory rate of 30 percent (which rate can be reduced or eliminated by treaty), and is levied on the branch's dividend equivalent amount. The branch profits tax generally replaces the second-tier withholding tax (discussed above) which the United States imposes, after the 1986 Act, only in the absence of a branch profits tax.

In addition to the branch profits tax, the 1986 Act contained a provision which provides for a 30-percent (or lower treaty rate) tax to be levied on any foreign corporation that deducts interest allocable to its U.S. branch but not actually paid by the branch (a branch-level interest tax).

Under the proposed treaty, a company that is a resident of India is subject to the branch profits tax and branch-level interest tax imposed by the United States on the profits attributable to, or interest payments allocable to, a permanent establishment in the

United States. For purposes of this permanent establishment tax, profits or interest attributable to a permanent establishment include any amounts subject to tax in the United States under Article 6 (Income From Immovable Property (Real Property)), Article 12 (Royalties and Fees for Included Services), or Article 13 (Gains). The permanent establishment tax on business profits (the branch profits tax) is imposed at the applicable rate provided in the proposed treaty for dividends received by a substantial shareholder (15 percent). The permanent establishment tax on interest (the branch-level tax on interest) is imposed at the applicable rates provided in the proposed treaty for interest received (15 percent in general, or 10 percent in the case of a financial institution).

Paragraph V (Ad Article 14) of the proposed protocol specifies that profits taxable in the United States as income from immovable property (Article 6), royalties and fees for included services (Article 12), and gains (Article 13) are subject to the permanent establishment tax only to the extent that such profits are subject to U.S. taxation on a net basis (i.e., by virtue of being effectively connected, or being treated as effectively connected, with the conduct of a trade or business in the United States). Any income that is subject to U.S. tax on a gross basis under Article 6, 12, or 13 is not subject to the permanent establishment tax under Article 14.

Article 14 of the proposed treaty also permits India to impose additional taxation on a permanent establishment of a U.S. company in India. The proposed treaty permits India to tax a U.S. company at a higher rate than that applicable to domestic companies. The difference in rates, however, may not exceed the existing difference of 15 percentage points.

In addition, in the case of a banking company that is a resident of the United States, any interest paid by the permanent establishment of such a company in India to the head office may be subject in India to an additional tax, imposed at the same 10-percent rate applicable under the U.S. permanent establishment tax to interest paid to a bank.

Article 15. Independent Personal Services

The United States taxes the income of a nonresident alien at the regular graduated rates if the income is effectively connected with the conduct of a trade or business in the United States by the individual. (See discussion of U.S. taxation of business profits under Article 7.) The performance of personal services within the United States can constitute a trade or business within the United States (Code sec. 864(b)).

The proposed treaty limits the right of a country to tax income from the performance of personal services by a resident of the other country. Under the proposed treaty, income from the performance of independent personal services (i.e., as an independent contractor) is treated separately from salaries, wages, and similar remuneration received by employees.

Under the proposed treaty, income derived by an individual resident in one country from personal services performed in an independent capacity in the other country may be taxed in the other country only if one of two threshold tests is met. First, the nonresident country may tax the income if the individual has a fixed base regularly available to him or her in the nonresident country for the purpose of performing his or her activities. Only that portion of the individual's income attributable to the fixed base may be taxed in the nonresident country. However, that portion may be taxed in the nonresident country even if payment of the income is deferred until the fixed base has ceased to exist (Paragraph III of the proposed protocol). Second, the nonresident country may tax the individual's independent personal services income if the individual is present in the nonresident country for more than 90 days during the taxable year concerned. By contrast, the U.S. model contains only the first threshold test, and thus does not allow a country to tax independent personal services income on the basis of length of stay alone. However, other recent U.S. income tax treaties with developing countries, such as those with Jamaica, the Philippines, and Barbados, have contained such provisions expanding the source country's right to tax independent personal services income.

The term "personal services" is defined in the treaty to include independent scientific, literary, artistic, educational, and teaching activities, as well as the independent activities of physicians, surgeons, lawyers, engineers, architects, dentists, and accountants.

The provisions of the proposed treaty are similar to the corresponding provisions of the United Nations model treaty.

Article 16. Dependent Personal Services

Under the Code, the income of a nonresident alien from the performance of personal services in the United States is not taxed if the individual is not in the United States for at least 90 days during a taxable year, the compensation does not exceed $3,000, and the services are performed as an employee of a foreign person not engaged in a trade or business in the United States or they are performed for a foreign office or place of business of a U.S. person.

Under the proposed treaty, income from services performed as an employee in one country (the source country) by a resident of the other country (the residence country) is taxable only in the residence country if three requirements are met: (1) the recipient is present in the source country for fewer than 184 days during the taxable year; (2) the employer is not a resident of the source country; and (3) the compensation is not borne by a permanent establishment or a fixed base or a trade or business of the employer in the source country.

Compensation derived by a resident of one country as a member of the crew of a ship or aircraft operated in international traffic by an enterprise of the United States or India may be taxed in that country. Unlike the U.S. model treaty, but similar to the OECD and the United Nations model treaties, this tax jurisdiction is not exclusive.

As in the case of dividends, interest, and royalties, under the saving clause of Article 1(3) (General Scope) the United States may always tax its citizens on their income from personal services, even if they are resident in India.

Other articles of the proposed treaty deal with income treated as directors' fees (Article 17); income earned by entertainers and athletes (Article 18); remuneration and pensions in respect of government service (Article 19); private pensions, annuities, alimony and child support (Article 20); payments received by students and apprentices (Article 21); and payments received by professors, teachers, and research scholars (Article 22).

Article 17. Directors' Fees

Under the proposed treaty, directors' fees and similar payments derived by a resident of one country in the recipient's capacity as a member of the board of directors of a company that is a resident of the other country may be taxed in that other country.

This rule for directors' fees follows the OECD model treaty. It differs from the rule of the U.S. model treaty, which treats directors' fees as personal services income, primary taxing jurisdiction over which generally belongs to the country where the recipient resides. However, rules similar to that of the proposed treaty appear in several recent U.S. tax treaties, including the treaties with Jamaica, Barbados, China, Denmark, and Cyprus.

Article 18. Income Earned by Entertainers and Athletes

The proposed treaty contains a separate set of rules that apply to the taxation of income earned by entertainers and athletes. These rules apply notwithstanding the other provisions dealing with the taxation of income from personal services (Articles 15 and 16), and are intended, in part, to prevent entertainers and athletes from using the treaty to avoid paying any tax on their income earned in one of the countries. Entertainers may be able to earn substantial income without crossing over any of the other thresholds that permit source-country taxation under the treaty, since these thresholds generally look to permanent or extended contacts, while entertainers can earn substantial fees in a matter of hours.

Under the proposed treaty, income derived by entertainers and athletes resident in one country from their personal activities in the other country (source country) generally may be taxed in the source country. However, such income may not be taxed by the source country if the entertainer's gross receipts (excluding expenses) do not exceed $1,500 in the taxable year (or the equivalent in Indian rupees). Although the dollar amounts are considerably lower than that in the U.S. model treaty ($20,000 including expenses), they are closer to other recent U.S. treaties with developing countries, such as the Philippines ($100 per day/$3,000 per year) and Barbados ($250 per day/$4,000 per year).

The proposed treaty also provides that if income for personal activities performed by an entertainer or athlete in the individual's capacity as such accrues not to the entertainer or athlete but to another person, that income may be taxed by the country in which the activities are performed. (This provision applies notwithstanding the business profits and personal services articles (Articles 7, 15, and 16)). This provision is intended to prevent highly paid performers and athletes from avoiding tax in the country in which they perform by routing the compensation for their services through a third person such as a personal holding company or a trust located in a country that does not tax the income. This provision does not apply if it is established that the entertainer does not participate directly or indirectly in the profits of the entity receiving the income. For example, this provision does not apply to a typical symphony orchestra, because the musicians are salaried employees with no right to a share of profits. The corresponding provision of the U.S. model treaty is substantially the same.

The proposed treaty provides that the lower thresholds for source-country taxation established by this article do not apply to entertainers supported by public funds of the country of residence (including its political subdivisions and local authorities). Thus, the source country's right to impose tax in that case is determined under the general rules of Articles 7 (Business Profits), 15 (Independent Personal Services), 16 (Dependent Personal Services), and 19 (Remuneration and Pensions in Respect of Government Service). The U.S. model treaty does not contain such a rule, which relieves state-supported entertainers from source country taxation in some cases.

The proposed treaty also contains a provision that permits the competent authorities to increase the thresholds of taxation applicable under this article in order to reflect economic or monetary developments.

Article 19. Remuneration and Pensions in Respect of Government Service

The proposed treaty contains the standard provision that generally exempts the wages of employees of one of the countries from tax by the other country.

Under the proposed treaty, remuneration, other than a pension, paid by a country or one of its political subdivisions or local authorities to an individual for services rendered to that country (or subdivision or authority) generally is taxable only in that country. However, if the services are performed in the other country, such remuneration is taxable only in the country of performance if the individual is a resident of the country of performance who either (1) is a citizen of that country or (2) did not become a resident of that country solely for the purpose of rendering the services. Thus, for example, India may not tax the compensation of a U.S. citizen and resident (not an Indian citizen) who is in India to perform services for the U.S. government, and the United States may not tax the compensation of an Indian citizen and resident (not an U.S. citizen) who performs services for the Indian Government in the United States.

Any pension paid by, or out of funds created by, a country or one of its political subdivisions or local authorities to an individual for services rendered to that country (or subdivision or authority) generally is taxable only in that country. However, such pensions are taxable only in the other country if the individual is both a resident and a citizen of that other country.

In the situations described above, the U.S. model treaty allows exclusive taxing jurisdiction to the paying country, but only in the case of payments to one of its citizens. The provision in the proposed treaty follows the corresponding provision in the OECD and United Nations model treaties.

If a country or one of its political subdivisions or local authorities is carrying on a business (as opposed to functions of a governmental nature), the provisions of Articles 16 (Dependent Personal Services), 17 (Directors' Fees), 18 (Income Earned by Entertainers and

Athletes), and 20 (Private Pensions, Annuities, Alimony and Child Support) apply to remuneration and pensions for services rendered in connection with that business.

Under paragraph 4(b) of Article 1 (General Scope), the saving clause does not apply to this provision insofar as it confers benefits on individuals who are not citizens of and who do not have immigrant status in the taxing country.

Article 20. Private Pensions, Annuities, Alimony and Child Support

Under the proposed treaty, a pension or annuity paid to a resident of either country from sources within the other country generally is subject to tax only in the recipient's country of residence. However, pensions paid by, or out of funds created by, a country or one of its political subdivisions or local authorities to an individual for services rendered to that country (or subdivision or authority) generally are taxable only in that country unless the individual is both a resident and a citizen of that other country (see Article 19). In addition, social security benefits and other public pensions paid by one country to an individual who is a resident of the other country or to a U.S. citizen are taxable only in the paying country. This rule, which is not subject to the saving clause of paragraph 3 of Article 1 (General Scope), exempts U.S. citizens and residents from U.S. tax on Indian social security payments. The United States may continue to tax U.S. social security payments to Indian residents, whether or not they are U.S. citizens. The article thus safeguards the United States' right under the Social Security Amendments of 1983 to tax a portion of U.S. social security benefits received by higher income individuals, while protecting any such individuals residing in India from double taxation.

The proposed treaty defines a pension as a periodic payment made in consideration of past services or by way of compensation for injuries received in the course of performance of services. This definition excludes a lump-sum pension benefit, which is generally understood to be covered by the corresponding article of the U.S. model treaty. The proposed treaty defines annuities as stated sums paid periodically at stated times during life or during a specified or ascertainable number of years, under an obligation to make the payments in return for adequate and full consideration in money or money's worth (but not for services rendered).

The proposed treaty provides that alimony paid to a resident of a country may only be taxed in the country of residence. The term "alimony" is defined to mean periodic payments under a written separation agreement or a decree of divorce, separate maintenance, or compulsory support, that are taxable to the recipient in the country of residence.

Conversely, the proposed treaty provides that periodic payments for the support of a minor child under a written separation agreement or a decree of divorce, separate maintenance, or compulsory support may be taxed only by the source country.

The provisions of this article are generally similar to the comparable provisions of the U.S. model treaty.

Article 21. Payments Received by Students and Apprentices

A student or business apprentice who is present in one of the countries principally for the purpose of his or her education or training, and is a resident of the other country or was such a resident immediately before visiting the host country, is exempt under the proposed treaty from tax in that country with respect to payments received from outside the host country for the purposes of the individual's maintenance, education, or training. For this purpose, the proposed treaty defines a resident of a country to include any individual who is resident in that country either in the taxable year in which the individual visits the host country or in the immediately preceding taxable year. Currently, payments from outside the host country are understood by Treasury to mean payments other than those paid by a U.S. citizen or resident (including the U.S. Government or any political subdivision, local authority, or agency or instrumentality) or borne by a permanent establishment in the United States.

In addition, in the case of grants, scholarships, and remuneration from employment not covered by that exemption, such a student or business apprentice is entitled during the period of education or training to the same tax exemptions, reliefs or reductions available to residents of the host country.

The benefits of Article 21 extend only for as long as is reasonably or customarily required to complete the education or training.

This exemption for visiting students and business apprentices is broader than that provided in the U.S. and OECD model treaties. The granting of host-country tax allowances follows the United Nations model treaty, but is not found in either the U.S. or the OECD model treaties.

Article 22. Payments Received by Professors, Teachers and Research Scholars

The proposed treaty provides that an individual who visits one country for the purpose of teaching or engaging in research at a university, college, or other recognized educational institution in that country is exempt from tax in that country for two years on remuneration for that teaching or research if the individual was a resident of the other country immediately before visiting the host country. Under this provision, for example, a U.S. professor who visits India for nine months for the purpose of teaching at an Indian university is exempt from Indian tax on remuneration the professor receives for the teaching. However, the professor may be taxed by India under the 90-day-presence-rule of Article 15 on any independent personal services income (e.g., income from consulting) that the professor earns while in India.

The research exemption in the proposed treaty is expressly limited to income from research undertaken in the public interest rather than primarily for private benefit.

The U.S., OECD, and United Nations model treaties do not contain a special exemption for visiting teachers and researchers. However, a number of U.S. income tax treaties provide a similar exemption for visiting teachers and researchers.

Article 23. Other Income

This article is a catch-all provision intended to cover items of income not specifically covered in other articles, and to assign the right to tax income from third countries to either the United States or India. Thus, it applies to income from third countries as well as to income from the United States and India.

As a general rule, items of income not otherwise dealt with in the proposed treaty that are derived by residents of either country are taxable only in the country of residence. This rule, for example, gives the United States the sole right under the treaty to tax income sourced in a third country and paid to a resident of the United States. This article is subject to the saving clause of paragraph 3 of Article 1 (General Scope) in the case of U.S. citizens, so U.S. citizens who are Indian residents continue to be taxable by the United States on their third-country income, with a foreign tax credit provided for income taxes paid to India.

This general rule does not apply if the recipient of the income (other than income from real property (Article 6)) is a resident of one country and carries on business in the other country through a permanent establishment or a fixed base, and the income is attributable to the permanent establishment or fixed base. In such a case, the provisions of Article 7 (Business Profits) or Article 15 (Independent Personal Services), as the case may be, apply.

Moreover, notwithstanding either of the above two rules, if a resident of one country receives income not dealt with elsewhere in the treaty that arises in the other country, the income may be taxed in that other (source) country. A number of existing U.S. income tax treaties apply this rule, but it is not included in the U.S. and OECD model treaties, which generally give the sole right to tax "other income" to the country of residence. This article is substantially the same as the corresponding article of the United Nations model treaty.

Article 24. Limitation on Benefits

The proposed treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and India as they apply to residents of the two countries. At times, however, residents of third countries attempt to use a treaty. This use is known as "treaty shopping." Under certain circumstances, and without appropriate safeguards, the nonresident is able to secure treaty benefits by establishing a corporation (or other entity) in one of the countries which, as a resident of that country, is entitled to the benefits of the treaty. Additionally, it may be possible for the third-country resident to repatriate funds to that third country from the entity under favorable conditions (i.e., it may be possible to reduce or eliminate taxes on the repatriation) either through relaxed tax provisions in the distributing country or by passing the funds through other treaty countries (essentially, continuing to treaty shop), until the funds can be repatriated under favorable terms.

The proposed treaty contains a provision intended to prevent third-country companies that are not bona fide residents of the

United States or India from using the treaty to secure certain treaty benefits.

Under this rule, and subject to certain exceptions, a resident (other than an individual) of one country that derives income from the other country is not entitled to relief from taxation in the source country otherwise provided by Articles 6 through 25, if either of two conditions is met. First, treaty benefits are denied if 50 percent or less of the beneficial interest in the resident is owned, directly or indirectly, by any combination of individual residents of India, citizens or residents of the United States, other individuals subject to worldwide taxation in either India or the United States, or the Governments of India or the United States (or any political subdivisions or local authorities). This rule is not as strict as that in the U.S. model treaty, which requires 75 percent ownership by residents of the entity's country of residence to preserve benefits.

Second, treaty benefits are denied if the income of the resident is primarily used to make deductible payments to third-country residents (who are not U.S. citizens). The Treasury Department's technical explanation of the proposed treaty says that this rule will generally be interpreted to apply if the entity pays out 50 percent or more of its gross income in deductible payments, such as interest and royalties. The purpose of this latter requirement, generally referred to as a "blue erosion" rule, is to prevent residents of third countries from utilizing a company resident in either the United States or India which meets the ownership requirements, but pays out a substantial portion of its income to such third-country residents in the form of deductible expenses. This provision is substantially the same as that in the U.S. model treaty.

Two general exceptions apply to the rules denying treaty benefits. First, treaty benefits are preserved if the resident entity's income is derived in connection with, or is incidental to, the active conduct of a trade or business in the source country. However, this exception does not apply (and benefits are therefore denied) to an entity in the business of making or managing investments, unless the business activities are banking or insurance activities conducted by a bank or insurance company. This active trade or business rule replaces a more general rule in the U.S. model treaty that preserves benefits if an entity is not used "for a principal purpose of obtaining benefits" under a treaty.

The second major exception to the general rules denying treaty benefits applies to publicly traded companies. Under this exception, a company is not denied benefits if there is substantial and regular trading in its principal class of shares on a recognized stock exchange (which term is restrictively defined).

The proposed treaty contains a rule not found in the U.S. model treaty that permits the competent authority of the country in which the income arises to waive the provisions of Article 24 and grant the otherwise-available benefits of the proposed treaty. The proposed treaty provides no guidance as to how that discretion is to be exercised.

Article 25. Relief from Double Taxation

In general

One of the two principal purposes for entering into an income tax treaty is to limit double taxation of income earned by a resident of one of the countries that may be taxed by the other country. The United States seeks unilaterally to mitigate double taxation by generally allowing U.S. taxpayers to credit the foreign income taxes that they pay against the U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets U.S. tax on foreign source income only. This limitation is generally computed on a worldwide consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income.

The limitation is computed separately for certain classifications of income (e.g., passive income, high withholding tax interest, financial services income, shipping income, dividends from noncontrolled section 902 corporations, DISC dividends, FSC dividends, and taxable income of a FSC attributable to foreign trade income) in order to prevent the averaging of foreign taxes on certain types of traditionally high-taxed foreign source income against the U.S. tax on certain items of traditionally low-taxed foreign source income. Also, a special limitation applies to the credit for foreign taxes imposed on oil and gas extraction income.

Foreign tax credits generally cannot exceed 90 percent of the pre-foreign tax credit tentative minimum tax (determined without regard to the net operating loss deduction). However, no such limitation will be imposed on a corporation if more than 50 percent of its stock is owned by U.S. persons, all of its operations are in one foreign country with which the United States has an income tax treaty with information exchange provisions, and certain other requirements are met. The 90 percent alternative minimum tax foreign tax credit limitation, enacted in 1986, overrode contrary provisions of then-existing treaties.

An indirect or "deemed-paid" credit is also provided. A U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation (or an inclusion of the foreign corporation's income) is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid for the year the dividend is received and go into the relevant pool or pools of separate limitation category taxes to be credited.

Unilateral efforts to limit double taxation are imperfect. Because of differences in rules as to when a person may be taxed on business income, a business may be taxed by two countries as if it were engaged in business in both countries. Also, a corporation or individual may be treated as a resident of more than one country and be taxed on a worldwide basis by both.

Part of the double tax problem is dealt with in other articles that limit the right of a source country to tax income and that coordinate the source rules. This article provides further relief where both India and the United States will still tax the same item of income. India waives its overriding taxing jurisdiction to the extent that this article applies; the United States does the same with respect to U.S. residents who are not U.S. citizens.

The proposed treaty provides rules for relief from double taxation through credits for foreign taxes paid to the United States and India. This provision generally follows the U.S. model treaty with respect to U.S. residents and the OECD model treaty with respect to Indian residents.

United States

Under the proposed treaty, the United States allows a foreign tax credit to a U.S. resident or U.S. citizen for income tax paid to India by or on behalf of the U.S. resident or citizen. The proposed treaty further provides that the United States is to allow a deemed paid credit to a U.S. corporate shareholder of an Indian company receiving a dividend from the Indian company if the U.S. corporate shareholder owns 10 percent or more of the voting stock in the Indian company. This credit is allowed for the income tax paid to India, by or on behalf of the distributing Indian company, on the profits out of which the dividends are paid. Both the regular and deemed paid foreign tax credits are to be determined in accordance with the provisions of U.S. law (as it may change from time to time, but without changing the general principles of this rule).

The proposed treaty provides that all Indian taxes covered by the treaty (Article 2) are considered income taxes for purposes of the U.S. foreign tax credit. Accordingly, all such Indian taxes are eligible for the U.S. foreign tax credit under the proposed treaty.

India

The proposed treaty provides that India is to permit a deduction from (i.e., a credit against) the Indian tax imposed on an Indian resident in the amount equal to the U.S. income tax payable under the treaty (whether directly or by deduction) on the Indian resident's U.S. source income. The deduction does not exceed that part of the Indian tax (computed before the deduction) which is attributable to the Indian resident's U.S. source income. The proposed treaty further provides that, in the case of an Indian company subject to surtax, the deduction is to be taken first against income tax with the remainder, if any, taken against surtax.

Source rule

The double taxation article contains a special source rule. Income derived by a resident of one country that may be taxed in the other country under the proposed treaty is deemed to arise in that other country, while income derived by a resident of one country that may not be taxed in the other country under the proposed treaty is deemed to arise in the country of residence. The source of income determines whether or not a credit is allowable for foreign taxes paid with respect to that income, inasmuch as both countries allow foreign tax credits only with respect to foreign source income.

However, any statutory source rules that apply for the purpose of limiting the foreign tax credit generally take precedence over the special source rule provided in Article 25; the one exception is income treated under Article 12 (Royalties and Fees for Included Services), which is subject to the special source rule provided in Article 25 but not to any statutory source rules. Thus, any income that may be taxed by India under Article 12 is treated as Indian source income for purposes of the U.S. foreign tax credit for Indian taxes covered by the proposed treaty, regardless of where the activities giving rise to the income take place. The source rules of Article 25 are expressly limited to the double tax relief article, as is the corresponding source rule of the U.S. model.

Article 26. Non-discrimination

The proposed treaty contains a nondiscrimination article relating to the taxes covered by the treaty. It is similar to the nondiscrimination article in the U.S. model treaty and to nondiscrimination articles that have been embodied in other recent U.S. income tax treaties.

In general, under the proposed treaty, one country cannot discriminate by imposing other or more burdensome taxes (or requirements connected with taxes) on nationals of the other country than it would impose on its nationals in the same circumstances. Under both the proposed treaty and the U.S. model, this provision applies whether or not the nationals in question are residents of one or both of the countries. The proposed treaty does not include the qualification, specified in the U.S. model, that a U.S. national residing outside the United States and a national of India residing outside the United States are not in the same circumstances for U.S. tax purposes. However, the Treasury's technical explanation of the proposed treaty states that a U.S. national residing outside the United States and a national of India residing outside the United States are not in the same circumstances, therefore the United States is not obligated under this provision to apply the same taxing regime to such persons.

As indicated above (under Article 3), "nationals" are defined as individuals having the nationality or citizenship of the United States or India, as the case may be. Under this definition, as under the U.S. model treaty, only U.S. citizens qualify as U.S. nationals for purposes of obtaining nondiscrimination benefits.

Under the proposed treaty, neither country may tax a permanent establishment of an enterprise of the other country less favorably than it taxes its own enterprises carrying on the same activities. Consistent with the U.S., OECD, and United Nations model treaties, however, a country is not obligated to grant residents of the other country any personal allowances, reliefs, or reductions for tax purposes on account of civil status or family responsibilities which it grants to its own residents. In addition, the proposed treaty specifies that this article does not prevent either country from imposing taxation consistent with the head office deduction limitations of paragraph 3 of Article 7 (Business Profits) or the permanent establishment tax under Article 14. The Treasury's technical explanation of the proposed treaty states the understanding that the withholding requirements on U.S. partnerships with foreign partners, imposed under Code section 1446, do not discriminate against partners resident in India (as compared to partners resident in the United States) within the meaning of Article 26.

Each country is required (subject to the arm's-length pricing rules of Articles 9(1) (Associated Enterprises), 11(7) (Interest), and 12(8) (Royalties and Fees for Included Services)) to allow its residents to deduct interest, royalties, and other disbursements paid by them to residents of the other country under the same conditions that it allows deductions for such amounts paid to residents of the same country as the payor. The Treasury Department's technical explanation of the proposed treaty states that the term "other disbursements" is understood to include a reasonable allocation of executive and general administrative expenses, research and development expenses, and other expenses incurred for the benefit of a group of related persons which includes the person incurring the expense.

The rule of nondiscrimination also applies to corporations of one country that are owned in whole or in part by residents of the other country. Enterprises resident in one country, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one of more residents of the other country, is not subjected in the first country to any taxation or any connected requirement that is other or more burdensome than the taxation and connected requirements that the first country imposes or may impose on its similar enterprises. The Treasury's technical explanation of the proposed treaty states the understanding that both the rules for taxing liquidating distributions to foreign corporations under Code section 367(e)(2), and the ineligibility of U.S. corporations with nonresident alien shareholders to make elections under subchapter S of the Code, do not discriminate against Indian-owned corporations within the meaning of Article 26.

The nondiscrimination article does not override the right of the United States to tax foreign corporations on their dispositions of U.S. real property interests because the effect of the provisions imposing such tax is not discriminatory. The election to be treated as a U.S. corporation under Code section 897(i) precludes the possibility of discrimination.

The scope of the nondiscrimination article in the proposed treaty is limited to the taxes that are covered by the agreement (i.e., national-level income taxes). Thus, in this respect the proposed treaty's protection is narrower than the U.S. model treaty, which applies to all national, state, and local taxes.

As provided in paragraph 4(a) of Article 1 (General Scope), the saving clause of paragraph 3 of Article 1 does not apply to Article 26.

Article 27. Mutual Agreement Procedure

The proposed treaty contains a mutual agreement provision that authorizes the competent authorities of the United States and India to consult together to attempt to alleviate individual cases of double taxation not in accordance with the proposed treaty. The saving clause of the proposed treaty does not apply to this article, so that the application of this provision may result in waiver (otherwise mandated by the proposed treaty) of taxing jurisdiction by the country of citizenship or residence. The mutual agreement provision of the proposed treaty generally follows the standard provision of the U.S. model, with a few differences that follow the corresponding provisions of the OECD or United Nations models.

Under the proposed treaty, a person who considers that the actions of one or both of the countries will cause the person to pay a tax not in accordance with the treaty may present a case to the competent authority of the country of which the person is a resident or national. As in the OECD model treaty, the case must be presented to the competent authority within three years of the date notice is received of the action which gives rise to taxation not in accordance with the treaty. By contrast, the U.S. model treaty imposes no time limit on the presentation of a person's case.

Upon the presentation of a person's case, the competent authority will make a determination as to whether the objection appears justified. If the objection appears to the competent authority to be justified and if it is not itself able to arrive at a satisfactory solution, then the competent authority will endeavor to resolve the case by mutual agreement with the competent authority of the other country, with a view to the avoidance of taxation that is not in accordance with the treaty. This provision requires the waiver of the internal statute of limitations of either country so as to permit the issuance of a refund or credit notwithstanding that statute of limitations. However, the provision does not authorize the imposition of additional taxes after the statute of limitations has run.

The competent authorities of the countries are to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the treaty. They may also consult together for the elimination of double taxation in cases not provided for in the treaty. Unlike the U.S. model treaty, the proposed treaty does not enumerate particular matters as to which the competent authorities might agree. The Treasury's technical explanation of the proposed treaty states the understanding that the powers of the competent authorities are generally as broad under the proposed treaty as under the U.S. model.

The proposed treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of this mutual agreement article. This provision makes clear that it is not necessary to go through diplomatic channels in order to discuss problems arising in the application of the treaty. It also removes any doubt as to restrictions that might otherwise arise by reason of the confidentiality rules of the United States or India. In addition, as in the United Nations model, the proposed treaty specifically authorizes the competent authorities to develop bilateral and unilateral procedures for the implementation of the mutual agreement procedure.

Article 28. Exchange of Information and Administrative Assistance

This article forms the basis for cooperation between the two countries in their attempts to deal with avoidance or evasion of their respective taxes and to obtain information so that they can properly administer the treaty. It follows the exchange of information article of the U.S. model treaty, with some modifications. It is also similar to the exchange of information articles found in the United Nations and OECD model treaties.

The proposed treaty provides for the exchange of information, including documents, as necessary to carry out the provisions of the proposed treaty or the provisions of the domestic laws of the two countries concerning taxes to which the treaty applies insofar as the taxation under those domestic laws is not contrary to the treaty. Following the United Nations model treaty, the proposed treaty adds that such exchange of information is particularly for the prevention of fraud or evasion of the covered taxes.

The exchange of information under the proposed treaty is not restricted by Article 1 (General Scope); thus, information concerning third-country residents is covered. The U.S. model treaty provides for the exchange of information regarding all taxes imposed by either country (whether or not otherwise covered by the treaty). The exchange of information provided for in the proposed treaty is somewhat more specified, though broader than the general scope of the treaty. In the case of India, the proposed treaty authorizes the exchange of information regarding income, wealth and gift taxes. However, the United States can request the exchange of information concerning a broader range of taxes, consisting of all taxes under the Internal Revenue Code.

Any information exchanged is to be treated as secret in the same manner as information obtained under the domestic laws of the receiving country. If the information is originally regarded as secret in the transmitting country, the exchanged information may be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes to which the treaty applies. Such persons or authorities can use the information for such purposes only. They may disclose the information in public court proceedings or in judicial decisions. Persons involved in the administration of taxes include legislative bodies involved in oversight of the administration of taxes, including their agents such as, for example, the U.S. General Accounting Office, with respect to such information as they consider necessary to carry out their oversight responsibilities. The proposed treaty specifies that the competent authorities must develop conditions, methods, and techniques concerning the matters respecting which information will be exchanged.

The proposed treaty specifies that the exchange of information or documents may be either on a routine basis or on request with reference to particular cases, or otherwise. The proposed treaty also specifies that the competent authorities of the two countries may agree on the information or documents to be furnished on a routine basis.

The proposed treaty contains limitations on the obligations of the countries to supply information. A country is not required to carry out administrative measures at variance with the law and administrative practice of either country, or to supply information which is not obtainable under the laws or in the normal course of the administration of either country, or to supply information that would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

Upon an appropriate request for information, the requested country is to obtain the information to which the request relates in the same manner as if its tax were at issue. A requested country is to use its subpoena or summons powers or any other powers that it has under its own laws to collect information requested by the other country. It is intended that the requested country may use those powers even if the requesting country could not under its own laws. Thus, it is not intended that this provision be strictly reciprocal. For example, once the Internal Revenue Service has referred a case to the Justice Department for possible criminal prosecution, the U.S. investigators can no longer use an administrative summons to obtain information. If, however, India could still use an administrative summons to obtain requested information, it would be expected to do so even though the United States could not. The United States could not, however, tell India which of its procedures to use.

Where specifically requested by the competent authority of one country, the competent authority of the other country is to provide the information in the form requested. Specifically, the competent authority of the second country is to provide depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings) to the extent that they can be obtained under the laws and practices of the second country in the enforcement of its own tax laws.

The U.S. model treaty provides that each country is to collect taxes for the other country to the extent necessary to insure that benefits of the treaty are not going to persons not entitled to those benefits. The proposed treaty does not contain such a collection provision.

Article 29. Diplomatic Agents and Consular Officers

The proposed treaty contains the rule found in other U.S. tax treaties that its provisions are not to affect the privileges of diplomatic agents or consular officers under the general rules of international law or the provisions of special agreements. Accordingly, the treaty will not defeat the exemption from tax which a host country may grant to the salary of diplomatic officials of the other country. Because the saving clause applies only with respect to individuals who are citizens (or have immigrant status), U.S. diplomats who are Indian residents are not subject to Indian tax (unless they are citizens or immigrants of India). Similarly, Indian diplomats who are U.S. residents are not subject to U.S. tax (unless they are citizens or immigrants of the United States).

Article 30. Entry into Force

The proposed treaty states that each country is to notify the other country in writing, through diplomatic channels, upon the completion of their respective ratification procedures. In the United States, the ratification process is completed upon the signing of the ratification document by the President, on the advice and consent of the Senate. The proposed treaty will enter into force when the latter of the ratification notifications is exchanged. With respect to taxes withheld at source in the United States, the treaty is effective for amounts paid or credited on or after the first day of January following the treaty's entry into force. With respect to other taxes imposed by the United States, the treaty is effective for taxable periods beginning on or after the first day of January following the treaty's entry into force. With respect to taxes imposed by India, the treaty is effective for income arising in any taxable year beginning on or after the first day of April following the calendar year during which the treaty enters into force.

Article 31. Termination

This proposed treaty is to remain in force indefinitely, but either country may terminate it unilaterally by giving notice on or before June 30th in any calendar year after the expiration of a period of five years from the date on which the notice of termination is given. A termination would be effective for amounts paid or credited on or after the first day of January following the notice of termination with respect to taxes withheld at source in the United States. With respect to other taxes imposed by the United States, a termination would be effective for taxable periods beginning on or after the first day of January following the notice of termination. With respect to taxes imposed by India, a termination would be effective for income arising in any taxable year beginning on or after the first day of April following the calendar year during which the notice of termination is given.

Nothing in Article 31 affects the ability of the United States and India to enter into a superseding agreement or otherwise to bilaterally renegotiate the proposed treaty.

Exchange of Notes

At the signing of the proposed treaty, notes were exchanged dealing with three issues. First, the notes state that although both countries agreed not to include a tax-sparing credit in the proposed treaty, in the event that the United States amends its laws concerning the provision of tax-sparing credits or reaches agreement on the provision of a tax-sparing credit with any other country, the proposed treaty would be promptly amended to incorporate a tax-sparing credit. Such an amended treaty would be subject to the usual ratification procedures of both countries.

This discussion reflects the desire of India and other developing countries to have the United States adopt a tax-sparing credit. Many developed countries provide a tax-sparing credit in order to avoid what, in the view of some, is a conflict with the foreign investment incentive policies of developing countries. A tax-sparing credit is an income tax credit provided by a country (typically a developed country) against its own tax on income from a developing country. The credit equals the full amount of the developing country's nominal tax on the income, notwithstanding the developing country's reduction or elimination of the tax as part of an investment incentive program. Many developing countries, for example, provide "tax holidays" to residents of other countries who invest in the developing country. Generally, under these tax holidays, the developing countries forego tax on the profits from the foreign-owned business for a period of time. Absent a tax-sparing credit, those profits typically would be taxed in full by the country of residence of the business's foreign owner upon repatriation in dividend form. The United States has declined to give tax-sparing credits.

In addition, the diplomatic notes explain under what circumstances a person may be considered to habitually secure orders in one country, wholly or almost wholly for an enterprise, as discussed above under Article 5 (Permanent Establishment). Finally, the notes present the memorandum of understanding regarding the interpretation of aspects of Article 12 (Royalties and Fees for Included Services) relating to the scope of included services, as discussed above under Article 12.

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